

BANKING REGULATION

Its Purposes,
Implementation,
and Effects

Fifth Edition

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FOREWORD

Throughout U.S. history, banking regulation has been an important factor in establishing the role of banks within the financial system. This will continue to be true with the pathbreaking banking legislation that was passed in 1999 and with the many revolutionary changes that are taking place in our financial system today. Most notably, the 1999 legislation is opening the door for banking, securities, and insurance activities to be merged together. At the same time, technological innovation, new financial theories and ideas, changes in the competitive environment, and expanding international relationships are all leading to a remarkable transformation in how the financial system operates. Among the more significant and ongoing changes are interstate banking, banking over the Internet, a broad array of new financial services, and a rapid increase in our capacity to process and utilize financial information.

As a regional institution and an integral part of the nation's central bank, the Federal Reserve Bank of Kansas City places much emphasis on its role in monitoring developments within banking and promoting a stable and competitive financial system. The fifth edition of *Banking Regulation: Its Purposes, Implementation, and Effects* not only reflects these objectives, but reaffirms our intentions to bring about a greater understanding of the U.S. banking system and its supervisory framework.

The four previous editions of this book have been widely used by bankers, the general public, colleges and universities, and banking supervisors. I trust this fifth edition will continue to be a useful source of information on our supervisory process and the challenges we all face in maintaining a sound and innovative financial system.

THOMAS M. HOENIG
President

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INTRODUCTION

Banking and the regulation of banks have both been key elements in the development of the United States and its financial system. Banks have attained a unique and central role in U.S. financial markets through their deposit-taking, lending, and other activities. Banks hold the vast majority of deposits that are transferable by check. These demand deposit powers have allowed bankers to become the principal agents or middlemen in many financial transactions and in the nation's payments system. As a result, most payments in this country involve a bank at some point, and this payments system plays a vital role in enabling goods and services to be exchanged throughout our economy. In terms of deposit activities, banks are also important because individuals have traditionally placed a substantial amount of their funds in bank time and savings deposits.

On the lending side, banking organizations have significant flexibility in the types of borrowers they can accommodate. Banks are major lenders to the business sector and to individuals, and thus determine how a large portion of credit is to be allocated across the nation. Moreover, through a combination of lending and deposit activities, the banking system can affect the aggregate supply of money and credit, making banks a crucial link in the monetary mechanism and in the overall condition of the economy.

Other activities of banks are also of major consequence within the financial system and the overall economy. In particular, banking organizations, through the use of bank holding companies, are expanding into many new markets and financial services. In addi-

tion, banking legislation passed in 1999 allows banking organizations to set up financial holding companies and thereby participate more fully in insurance, securities, and merchant banking activities. Consequently, banking organizations can now provide a wide range of services, including insurance and securities brokerage and underwriting, mutual funds, leasing, data processing of financial information, and operation of thrift associations, consumer finance companies, mortgage companies, and industrial banks.

Given the overall importance of banks to the economy and the level of trust customers place in banks, few people would be surprised to find that governmental regulation and oversight extend to many aspects of banking. In fact, since banks first appeared in the United States, banking has been treated as an industry having strong public policy implications. The general public, bankers, and regulators have all played roles in developing the present system of banking laws and supervision. As a consequence, the regulatory system has been responsive to many different needs and now serves an important function in establishing many of the guidelines and standards under which banking services are provided to the public.

There are many reasons to study banking regulation and supervision, but two general objectives stand out. One is practical: we all conduct transactions through the financial system and deal with banks on a frequent basis. Some knowledge of bank regulations is helpful in carrying out these transactions, understanding how the banking system works, and judging the extent of regulatory protection being provided. Moreover, an understanding of banking regulation has assumed added importance with the growing complexity of the financial system and the recent passage of major banking legislation.

The other major reason for studying banking regulation is to ensure that this regulation both protects the public and fosters an efficient, competitive banking system. The actual benefits and costs of banking regulation, in fact, are a concern of many different groups. This attention originates from a number of factors,

including the overall importance of the banking industry to the economy and the financial problems encountered by some bank and thrift organizations in past years. Another concern is whether credit and other banking services flow evenly to different segments of the population. In addition, some contend that banking regulation may impose excessive cost burdens that hinder banks in providing services to their customers and in competing with other financial institutions.

The benefits and costs of banking regulation are also drawing attention because of many recent industry changes, such as electronic and internet banking, improved communications and data processing systems, and the development of new and more complex financial instruments and risk management practices. These revolutionary, technological changes are bringing banking closer to its customers, altering the way financial transactions and banking operations are conducted, and expanding the variety of services banks can provide.

All of these factors are prompting much debate over the appropriate regulatory framework for banks and the types of financial services banks should be able to offer. This debate is also focusing attention on what the basic objectives of bank regulation should be and how existing and proposed regulations will affect our financial system in the future.

The purpose of this book is to describe the current regulatory system and look at its influence on banks and their customers. The book further provides a perspective on how banking regulation developed and the specific reasons or purposes for regulating banks. In addition, it outlines many of the changes taking place in banking today and their implications for banking regulation.

Chapter 1 addresses the question of why banks are regulated in order to establish the basic purposes, rationale, and goals for banking regulation, and to provide a framework for evaluating bank regulations. Chapter 2 traces the history and development of U.S. banking regulation. Examined in this chapter are events that

helped create the present regulatory structure and the laws and regulations that were implemented in response to these events. Chapter 3 looks at what banks, bank holding companies, and financial holding companies are, while Chapter 4 discusses who regulates banks and covers the structure, general powers, and functions of the bank supervisory authorities.

Chapters 5, 6, and 7 examine many of the regulations that currently apply to banks. Each of these chapters is organized around one of the basic regulatory purposes presented in Chapter 1. The chapters discuss the major regulations serving each purpose, as well as how these regulations achieve their objectives and what considerations led to their implementation. Current issues and possible alternatives to these regulations are also explored. While the organization of these chapters provides a convenient means of presenting the material, the chapters should not be viewed as strict divisions between the various banking regulations. Some regulations are discussed in more than one chapter either because they serve more than one purpose or because their purpose has changed over time. These chapters and their organization, consequently, should be viewed as a means of identifying each regulation's place in the overall regulatory framework.

Finally, Chapter 8 reviews ongoing trends and unresolved issues in banking and its regulation. It then discusses what these developments might mean in the future for bank regulation and the supervisory process.

Although the book covers major banking regulations and many of their provisions, it provides neither detailed analyses nor specific interpretations of individual regulations themselves. In addition, since numerous changes are taking place in banking and its regulation, a number of regulations are likely to be revised in coming years. A note is made in the text covering revisions already known or proposed. Otherwise, regulations should be viewed as effective November 2000.

CHAPTER 1

Why Regulate Banks

Although banks are operated for profit and bankers are free to make many decisions in their daily operations, banking is commonly treated as a matter of public interest. Banking laws and regulations extend to many aspects of banking, including who can open banks, what products can be offered, and how banks can expand. Consequently, a familiarity with regulatory objectives and goals is essential for understanding how the U.S. system of bank regulation and supervision arose and what the purpose of particular regulations might be.¹

Much of the U.S. regulatory system has developed in response to financial crises and other historical and political events. No central architect was assigned to design the overall system or lay out a single set of principles. Instead, many people with many viewpoints, objectives, and experiences have been responsible for the current supervisory framework. As a consequence, bank regulation has evolved to serve numerous goals — goals which have changed over time and on occasion even been in conflict with one another.

The following sections focus on several of the more commonly accepted goals of bank regulation. Also, because of the potential for conflict among regulatory goals, special attention is given to what banking regulation should not do.

¹ Banking regulation in its strictest sense refers to the framework of laws and rules under which banks operate. Narrowly defined, supervision refers to the banking agencies' monitoring of financial conditions at banks under their jurisdiction and to the ongoing enforcement of banking regulation and policies. Throughout this book, however, regulation and supervision will be viewed in a more general sense and, in many cases, will be used interchangeably.

PROTECTION OF DEPOSITORS

The most basic reason for regulation of banking is depositor protection. Pressure for such regulation arose as the public began making financial transactions through banks, and as businesses and individuals began holding a significant portion of their funds in banks.

Banking poses a number of unique problems for customers and creditors. First, many bank customers use a bank primarily when writing and cashing checks and carrying out other financial transactions. To do so, they must maintain a deposit account. As a consequence, bank customers assume the role of bank creditors and become linked with the fortunes of their bank. This contrasts with most other businesses, where customers simply pay for goods or services and never become creditors of the firm.

A second problem for bank depositors is that under the U.S. fractional reserve system of banking, deposits are only partially backed by the reserves banks hold in the form of cash and balances maintained with the Federal Reserve. As a result, depositor safety is linked to many other factors as well, including the capital in a bank and the condition and value of its loans, securities, and other assets. A thorough investigation of these factors is likely to be too complex and costly for the vast majority of depositors, many of whom have accounts too small to justify the scrutiny that might be given to major investments. Even if depositors could accurately assess banks, this condition could change quickly whenever the economy changes or when banks take on new depositors or alter their asset holdings and commitments. In addition, an important part of the information needed to evaluate the condition of a bank may be confidential and unavailable to the public.

In summary, bank depositors may have more difficulty protecting their interests than customers of other types of businesses. While depositors could conceivably make general judgments about the condition of banks, the task would still be difficult,

costly, and occasionally prone to error. These facts, especially when combined with the history of depositor losses before federal deposit insurance, explain much of the public pressure for banking regulation to protect depositors.

MONETARY AND FINANCIAL STABILITY

Apart from just being concerned about individual depositors, banking regulation must also seek to provide a stable framework for making payments. With the vast volume of transactions conducted every day by individuals and businesses, a safe and acceptable means of payment is critical to the health of our economy. In fact, it is hard to envision how a complex economic system could function and avoid serious disruptions if the multitude of daily transactions could not be completed with a high degree of certainty and safety. Ideally, bank regulation should thus keep fluctuations in business activity and problems at individual banks from interrupting the flow of transactions across the economy and threatening public confidence in the banking system.

Historically, monetary stability became a public policy concern because the most severe economic downturns in U.S. history were typically accompanied and accentuated by banking panics. Before the creation of the Federal Reserve System in 1913 and the FDIC in 1933, these panics followed much the same pattern. Individual banks and the banking system as a whole held only a limited volume of internal reserves and liquid assets. Consequently, during serious banking and economic problems, these reserves could be quickly exhausted and the value of other bank assets could be put into question, thus giving depositors good reason to fear for the safety of their funds. Such disruptions in the banking system would further hinder financial transactions and the flow of credit, leading to continued slippages in the overall economy and in depositor confidence.

The Federal Reserve Act sought to prevent such situations by

providing for a more elastic reserve base and by allowing banks to borrow funds from Reserve banks to meet depositor needs and credit demands. To provide further confidence to depositors, the U.S. Government instituted federal deposit insurance in the 1930s. This insurance, by eliminating the link between the fate of small depositors and that of their banks, removed any reason for insured depositors to panic at the first sign of banking problems. Although deposit insurance has not been without cost or risk, it has provided stability in the payments system and given bank regulators greater flexibility in resolving individual bank problems.

Several other aspects of state and federal policy have also contributed to monetary stability in the United States. The Federal Reserve has responsibility for controlling the overall volume of money circulating throughout the economy and thus for providing a stable base for our payments system. Banks play an important role in this monetary system, since their deposit obligations make them the major issuers of money in the economy. This role is further acknowledged through specific laws and regulations determining which institutions can offer deposit accounts, the level of reserves that must be held against these accounts, and the various deposit reports that must be filed.

Another policy aspect of monetary stability is supervision and regulation of the banking system. To provide stability, banking regulation should foster the development of strong banks with adequate liquidity and should discourage banking practices that might harm depositors and disrupt the payments system.

In banking regulation, the objective of monetary stability has been closely linked with the goal of depositor protection. Financial crises and unintended fluctuations in the money supply have been prevented primarily by promoting confidence in banks and guaranteeing the safety of deposits. For that reason, regulations aimed at promoting depositor protection and a stable monetary transactions system are examined together in Chapter 5.

EFFICIENT AND COMPETITIVE FINANCIAL SYSTEM

Another aspect of a good banking system is that customers are provided quality services at competitive prices. One of the purposes of bank regulation, therefore, is to create a regulatory framework that encourages efficiency and competition and ensures an adequate level of banking services throughout the economy.

Efficiency and competition are closely linked together. In a competitive banking system, banks must operate efficiently and utilize their resources wisely if they are to keep their customers and remain in business. Without such competition, individual banks might attempt to gain higher prices for their services by restricting output or colluding with other banks. Competition is also a driving force in keeping banks innovative in their operations and in designing new services for customers. A further consideration is that for resources throughout the economy to flow to activities and places where they are of greatest value, competitive standards should not differ significantly across banking markets or between banking and other industries.

The promotion of an efficient and competitive banking system carries a number of implications for regulation. Competition and efficiency depend on the number of banks operating in a market, the freedom of other banks to enter and compete, and the ability of banks to achieve an appropriate size for serving their customers. For instance, too few banks in a market could encourage monopolization or collusion, while banks of a suboptimal size might be unable to serve major customers and might be operating inefficiently. Consequently, regulators must be concerned with the concentration of resources in the banking industry and with the opportunities for entry and expansion across individual banking markets.

Banking regulation must also take an approach that does not needlessly restrict activities of commercial banks, place them at a competitive disadvantage with less regulated firms, or hinder the

ability of banks to serve their customers' financial needs. Finally, regulation should foster a banking system that can adapt and evolve in response to changing economic conditions and technological advances.

CONSUMER PROTECTION

Another goal of banking regulation is to protect consumer interests in various aspects of a banking relationship. The previous regulatory objectives serve to protect consumers in a number of ways, most notably through safeguarding their deposits and promoting competitive banking services. However, there are many other ways consumers are protected in their banking activities. These additional forms of protection have been implemented through a series of legislative acts passed over the past few decades.

Several basic purposes can be found in this legislation. The first is to require financial institutions to provide their customers with a meaningful disclosure of deposit and credit terms. The main intent behind such disclosures is to give customers a basis for comparing and making informed choices among different institutions and financial instruments. The disclosure acts also serve to protect borrowers from abusive practices and make them more aware of the costs and commitments in financial contracts. A second purpose of consumer protection legislation is to ensure equal treatment and equal access to credit among all financial customers. The equal treatment acts can be viewed as the financial industry's counterpart to civil rights legislation aimed at ensuring equal treatment in such areas as housing, employment, and education. Other purposes associated with consumer protection include promoting financial privacy and preventing problems and abusive practices during credit transactions, debt collections, and reporting of personal credit histories.

Consumer protection objectives are generally consistent with good banking principles. In fact, credit and deposit disclosures and

informed customers should be of most benefit to bankers offering competitive services. Likewise, equal and nondiscriminatory treatment of borrowers is necessary for any banker aiming to maximize profits. The growing complexity of financial instruments and the uniqueness of individual customers, though, have made consumer protection a very complicated and detailed regulatory process.

WHAT BANK REGULATION IS NOT INTENDED TO ACCOMPLISH

Because bank regulation has been extended to cover a range of goals, there is always the possibility that it might be extended to areas that are not a proper concern for public policy. Thus, the limits of bank regulation can best be understood in terms of the things it should not try to do.

Is it the purpose of banking regulation, for example, to keep banks from failing? Provided insured depositors can be protected and adequate banking services can be maintained, preventing the failure of individual banks is not a primary focus of banking regulation. In cases where banks are failing, regulatory aid might serve only to protect those responsible for the bank's poor performance — its management and stockholders. Furthermore, in a dynamic banking system, regulation cannot prevent all banking failures, at least not at an acceptable cost. Even if failures could be prevented, the result would be to sacrifice some of the main objectives of regulation. For example, poorly managed banks and their stockholders might have to be protected from competition and the discipline of the marketplace, thus giving them further incentives to take excessive risks and avoid corrective actions. Such protection might also leave the customers of these banks with overpriced, low-quality services. Finally, to prevent failures, regulators might have to impose tight restrictions on the entire banking industry, thus keeping well-managed banks from fully meeting the needs of their customers.

For the most part, the bank regulatory agencies have handled banking problems and failures with little disruption to depositors, other bank customers, and the local economy. Our deposit insurance system, for instance, has been able to protect most depositors at failed banks with such means as assumption of deposits by another bank or insured deposit payoffs or transfers. Through these actions, failing banks and their management and stockholders can be forced to bear the full consequences of their actions, and the deposits and many of the assets at these banks can be taken over by banks operated in a safer and more efficient manner.

Should bank regulation try to substitute government decisions for a banker's decisions in operating a bank? When bank examiners identify problems at banks, they may offer advice on how the problems could be corrected. The examiner is not in a position, however, to determine policy at a bank or to establish particular lending and investment practices. In fact, bank supervisors can often judge a banker's decisions only in retrospect. Credit decisions, for instance, might be based partly on characteristics of individual borrowers that only the lending officer understands. Also, a bank supervisor or examiner who spends only a few days or weeks in a bank cannot gather all the information available to the banker or fully comprehend all the policy decisions made in the bank. In meeting their own objectives, bank examiners and regulators must therefore be careful not to hinder banks as they serve the needs of their customers and the overall economy.

Should banking regulations and government policies favor certain groups over others? This kind of intervention in banking, except in cases of obvious distortions, is not desirable for several reasons. In a free society, market forces should be free to allocate credit and resources. Rules that interfere with the market are inconsistent with this principle and may have unforeseen side effects. Any such intervention in banking is often likely to be futile, or nearly so, since borrowers and other customers can fre-

quently shift their business into “favored” areas or switch to less regulated entities.

Consequently, banking regulation must be evenhanded in its effects on various groups. Regulation should not give preferential treatment to financial institutions or to their customers, and it should not favor one size or type of financial institution over another. For example, banks should not be protected from the competition of other institutions — nor other institutions from bank competition. In the interest of a competitive and efficient banking system, good bank regulation should have minimal effects on credit and resource allocation decisions and should not encourage costly efforts at circumvention.

CHAPTER 2

History of Banking Regulation

The U.S. banking system, as well as its regulation and regulatory objectives, has undergone many changes during the nation's history. The present regulatory system developed as the result of a series of experiments. When regulations were found inadequate, they were changed or discarded for a new regulatory structure. Regulations that were judged successful became the more permanent elements in the system. Because the U.S. banking system continues to change rapidly with financial and technological innovation, our regulatory system is still evolving in many significant ways.

The evolutionary nature of U.S. banking regulation has prompted some to characterize the system as “patchwork” or “crisis-built.” Perhaps if we were starting over to design a comprehensive and consistent regulatory structure, some of the features of our current system, such as federal and state bank chartering, the myriad of federal and state banking authorities, and the large number of small banks, might not be included. Nevertheless, the current system offers several advantages, such as widespread private ownership of banks and a diversity of banking services, and it has worked to the general satisfaction of much of the public. Because of its gradual development, U.S. banking regulation can best be understood by examining its evolution, its response to financial crises, and the specific reasons why many of its features were originally adopted.

EARLY AMERICAN BANKING

Commercial banking in this country developed slowly in the period before the Revolutionary War. British merchants wanted to control colonial finances, and the British Parliament cooperated by issuing the Currency Acts, which prohibited paper money of the colonies from being declared legal tender. In addition, banking experience in the colonies was limited, confined primarily to land banks and several early experiments with colonial money.

After the war, some states began chartering commercial banks by special acts of their legislatures. These banks typically took deposits and engaged in short-term lending. They also issued their own bank notes, which were partially backed by holdings of gold and silver coins. Bank notes were used in everyday business transactions and were often put into circulation in exchange for the promissory notes of bank borrowers. As a result, the soundness of state bank notes depended largely on their gold and silver backing and on the liquidity and risk in a bank's loan portfolio. Most of the early state banks were able to maintain the value of their notes by limiting the amount in circulation and by being selective in their lending operations. In response to such policies, the states played a very limited supervisory role in the early 1800s.

The federal government first entered into bank regulation in 1791 when, at the urging of Alexander Hamilton, Congress created the Bank of the United States. This bank operated under regular commercial banking principles but also assumed some functions of a central bank. Eighty percent of its stock was privately owned, and most of its income came from commercial banking. Under its central banking functions, the Bank of the United States acted as the principal depository and fiscal agent for the Treasury, as well as the country's main gold and silver depository. With a limit on circulation and with public confidence in a federal charter, the bank's notes usually held their value throughout the country. Since the bank ordinarily received a surplus of state bank notes over its own

notes, it was in a position to present the notes of other banks for redemption and thereby limit their circulation. The Bank of the United States further acted as a central bank by making loans to state banks with temporary liquidity problems.

Although the Bank of the United States fulfilled its role, congressional and state bank opposition kept it from being rechartered in 1811. However, banking problems led to a congressional chartering of a second Bank of the United States in 1816. This bank was organized much the same as the first, but, being much larger, it played an even greater central banking role. Because of political and state bank opposition, the second Bank of the United States met the same fate as its predecessor, and its charter was not renewed in 1836. The federal government thus removed itself from banking regulation and left the Treasury to attend to all federal banking functions until the national banking system was started nearly three decades later.

With a rapid expansion of state banks after 1836 and an increase in bank note problems and bank failures, states gradually began to assume more regulatory responsibilities. Early state regulation had been limited largely to the chartering of banks through special legislative acts. Such acts opened chartering to political favoritism, however, and public opinion eventually led to passage of "free banking" acts. The first free banking acts were passed in Connecticut, Michigan, and New York in 1837 and 1838, and other states later passed similar acts. Essentially incorporation laws, they allowed anyone meeting certain standards and requirements to secure a bank charter.

To protect bank customers, states also began supervising bank operations in a limited manner and designing note and deposit insurance systems. Between 1836 and 1863, state bank supervision primarily consisted of obtaining and reviewing bank statements of condition. Banks were seldom examined unless they were near insolvency. Most states required that bank notes and deposits be partially backed by gold and silver holdings, but some were lax in

enforcing these provisions. Bank deposit and note insurance plans and security-backed note systems were tried in a number of states before the Civil War. These plans, along with tighter supervision of the participating banks, helped create a more stable banking system. However, in other states and in many of the frontier territories, inadequate regulation of banks and over-issuance of notes led to a system where many bank notes circulated at a range of discounts and could not be readily redeemed for gold or silver specie.

Nevertheless, even with the costs of circulating and using such notes, banking in this period was important in financing early U.S. development. Moreover, most pre-Civil War bankers operated responsibly, given the difficulties in constructing a new banking system.

DEVELOPMENT OF DUAL BANKING AND THE NATIONAL BANK SYSTEM

As commercial trade became more important across the nation and bank note and currency problems continued, proposals for a uniform and stable national currency began to attract public interest. Several of the initial proposals for a national currency were strongly opposed by state bankers and others. However, in the early 1860s, political support mounted for a proposal that would provide for a national currency to be secured by U.S. Government bonds. The currency would be issued through a new system of national banks. The main appeal of this proposal at the federal level was that it would provide a steady market for the large amount of government bonds sold to finance the Civil War. The proposal became part of the National Currency Act of 1863, which was extensively rewritten and strengthened in the National Bank Act of 1864.

The National Currency and National Bank Acts brought the federal government into the active supervision of commercial banks. Until then, the only banks chartered at the federal level had

been the first and second Banks of the United States. The legislation of the 1860s established the Office of the Comptroller of the Currency, which was given the responsibility for chartering, supervising, and examining all national banks. Charters for national banks were to be available under the free banking system, provided minimum capital and other organizational requirements were satisfied. Every national bank could issue notes backed by U.S. bonds deposited with the Comptroller. The National Bank Act also required national banks to hold reserves against their notes and deposits. The reserves could be in the form of vault cash or deposits at national banks in one of 17 central reserve cities.

Because of tighter supervision and more restrictive lending and investment powers under the National Bank Act, few banks initially switched to national charters. To give banks more incentive to join the national bank system and to foster the development of a national currency, Congress imposed a prohibitive 10 percent tax on state bank notes in 1865. Most state banks soon took out national charters to avoid the earnings disadvantage of state notes. The tax on state bank notes thus gave impetus to the national banking system, which was expected to soon supplant the state banking system.

Two developments in the 1870s and 1880s, however, led to a resurgence in state bank chartering and firmly established state banks as an alternative to national banks. One was the growing use of checks. Checkable deposits increased rapidly in this period relative to bank notes as checks became more widely accepted and proved to be more convenient and safer to use in many transactions. This decline in the importance of bank notes served to eliminate much of the earnings advantage national banks held over state banks. The other development was a decline in the profits national banks could make on notes. Note profitability fell in the 1880s as a result of declining yields on bonds eligible for note backing. Because of these factors, the amount of national bank

notes in circulation fell by half in the 1880s and became a much less significant factor in banking.

DEVELOPMENT OF THE FEDERAL RESERVE SYSTEM

Both state and federal regulation increased between 1864 and the early 1900s, but financial panics and bank runs continued to occur. The National Bank Act, through its provisions for secured notes, had established the country's first uniform currency that circulated nationwide at par. However, as demand deposits became more important, the banking system struggled at times to provide a means for orderly conversions between such deposits and currency.

Significant changes in the public's deposit holdings — whether in response to changes in trade patterns, financial crises, or other factors — posed a problem for banks. Demand deposits were supported only fractionally by cash reserves, and no outside source of liquid reserves existed for the banking system as a whole. Consequently, any excess cash reserves in the banking system were quickly exhausted whenever much of the public sought to convert deposits into currency. Once cash reserves were exhausted, individual banks had no choice but to try liquidating their loan and investment portfolios in order to obtain the rest of the needed currency. Since deposits came to greatly exceed currency in circulation, no more than a fraction of the banks in a general panic could obtain enough currency by selling assets. These disruptions in the monetary system and in lending activities, when severe enough, would adversely affect commercial activity. Moreover, such downturns were likely to continue until the public gained enough confidence to return funds to the banking system and banks were again willing to expand their lending.

Several proposals were advanced during the early 1900s to correct for this “inelastic currency” and the lack of an outside source of reserves for the banking system. After much dispute over the

extent of private versus government control over a bank reserve system, congressional agreement was reached in 1913 with the Federal Reserve Act.

This act established the Federal Reserve System, to be headed by a board of seven members. To ease the concerns of bankers, businessmen, and others who feared centralized control over the country's banking and monetary system, Congress arranged for a Federal Reserve bank to be established in each of 12 districts. Membership in the Federal Reserve System was required for national banks and optional for state banks. Commercial banks that joined the system were required to buy stock in a district bank and could participate in the election of six of the nine reserve bank directors.

To correct for the inelasticity of currency, the Federal Reserve was given the power to rediscount the eligible paper of member banks. In this manner, a member bank could discount or borrow against its eligible assets and thereby obtain funds to meet a temporary cash drain or a rapid increase in credit demand. The administration of the discounting function initially was left to the district banks, with limited supervision by the Federal Reserve Board. The Federal Reserve was also given authority to hold the reserves of its member banks and to make open market purchases and sales of government securities. Because of its location near the major bond markets, the Federal Reserve Bank of New York eventually assumed open market operations for the system.

In addition, the act gave both the Comptroller of the Currency and the Federal Reserve System authority to supervise and examine member banks. This sharing of power caused some confusion, which was resolved in 1917. Since then, the Comptroller has examined and supervised national banks and provided their examination reports to the Federal Reserve, while the Federal Reserve has supervised state member banks.

GREAT DEPRESSION AND 1930s REFORM

After the Federal Reserve System was founded, the nation soon witnessed the deterioration of the international financial system during World War I, followed by postwar inflation, and then a short but severe contraction in the early 1920s. However, conditions stabilized after that and a long period of prosperity began, bringing with it rising public optimism.

Although no major shifts in bank regulation took place during this time, several notable changes occurred in banking services and the number of banks in operation. High business profits after 1921 spurred many banks to increase their commercial lending and securities activities. Several major banks, for instance, began expanding their trust operations and promoting affiliates engaged in the underwriting and distribution of securities. In addition, rapid urbanization during the decade prompted many larger banks to begin establishing branch networks wherever allowed by law. While the 1920s were a time of expansion for large banks, many failures and mergers of small banks took place in the rural areas that were forgotten in the prosperity of the 1920s. As a result, the number of banks in the United States began to fall from a peak of about 30,000 in 1921.

The Great Depression of the 1930s saw the most drastic financial decline in U.S. history. Commercial banking was probably affected as much or more than any other business. Bank failures accelerated after the stock market crash of 1929, as the public lost confidence in banks, and continued in waves until 1933. The banking collapse became so widespread that in 1933 President Roosevelt ordered all banks closed, a bank holiday that lasted from March 6 to March 13. Banks opened again only after state and federal regulators had examined their condition and issued a license to reopen. Many banks never reopened. By the end of that year, over 4,000 banks suspended operations or were absorbed by

other banks. This left fewer than 14,500 banks still in operation, less than half as many as in 1921.

After this experience, many regulators and legislators believed the existing regulatory system was still flawed and unable to deal with the basic banking troubles that appeared in the 1930s. Banking, once again, was vulnerable to shifts in public confidence, and instead of withstanding the financial collapse of the 1930s, the banking system was at the forefront of the crisis. Many reform measures were proposed during this time. Several of them were first introduced in the Banking Act of 1933 and then implemented more fully through the Banking Act of 1935.

The most significant change in the banking system incorporated in these acts was the federal insurance of deposits. The Federal Deposit Insurance Corporation (FDIC) was organized to carry out this provision, which initially provided insurance coverage of up to \$2,500 per depositor. As a result, insurance has been required of all Federal Reserve member banks since 1934 and extended to nonmember banks at their option and on approval of the FDIC. The insurance system has been funded by premiums paid by the insured banks.

The FDIC has come to mean several things for bank regulation. Most importantly, once the insurance system was established and began to prove itself, bank panics and the loss of public confidence became much less of a threat to the banking system. With insurance, all but the largest depositors were assured that they would not suffer a deposit loss even if their bank failed. In addition, since nearly all nonmember banks eventually took out FDIC insurance, federal supervision and examination was extended to almost the entire banking system. The FDIC was empowered to examine all insured banks. However, to prevent regulatory duplication, its supervision has been confined largely to insured state nonmember banks. Finally, with deposit insurance came a greater regulatory emphasis on reorganizing or merging a failing bank to maintain banking service and reduce financial disruption in its community.

Other banking changes were also incorporated into the Banking Acts of 1933 and 1935. First, insured banks were prohibited from paying interest on demand deposits, and provisions were made for the Federal Reserve Board and the FDIC to limit the interest rates banks could pay on time deposits. Interest ceilings were advocated under a disputed notion that paying higher deposit rates forced banks to try boosting revenue through riskier investment and lending policies. Second, in response to the stock market crash, investment banks were prohibited from affiliating with commercial banks, and bankers were restricted to a limited range of investment banking activities.

Third, after the failure of many small unit banks, the federal banking agencies were required to consider certain factors before allowing a bank to commence operations with deposit insurance. Among these factors were capital adequacy, earnings prospects, managerial character, and community need. As a result, the Banking Acts and the economic environment of the 1930s represented the final step in the decline of free banking and the beginning of more restrictive bank chartering. Fourth, the Federal Reserve Board was given authority to change reserve requirements for member banks within certain percentages. Finally, to encourage larger and more geographically diversified banks, Congress voted to allow national banks to form branch offices to the same extent as state banks.

These provisions and the advent of the FDIC not only changed commercial banking, but also altered the structure and division of power among the regulatory authorities. As many state banks took out federal deposit insurance, state banking agencies lost their position as sole regulators of state nonmember banks. However, in 1939, nonmember banks and the state agencies succeeded in getting a provision in the 1935 act removed, which would have required insured nonmember banks to join the Federal Reserve System. Also, the structure of the Federal Reserve System was changed in the Banking Acts. The acts centralized more power in the Federal Reserve Board,

increased its administrative responsibility in Reserve Bank supervisory duties, and established the Federal Open Market Committee to direct open market operations for the system.

A RAPIDLY EVOLVING BANKING SYSTEM

After the banking collapse of the 1930s, federal deposit insurance and the conservative attitudes of bankers who had survived the Great Depression helped to restore the banking system and lessen fears of future banking crises and depositor panics. This environment brought about a lengthy period of recovery. The next stage in U.S. banking history was initiated in the second half of the twentieth century, when the banking system found itself on the verge of many dramatic and innovative changes.

Pathbreaking technological advances in communications and data processing were beginning to pave the way for a vast array of new financial services and instruments. In addition, these advances were breaking down many of the traditional barriers that had effectively limited competition between banks and other parts of the financial system. Another result was to make multi-office banking much more feasible and desirable, thus helping to foster rapid banking consolidation and allow banking organizations to expand into new markets — either on an intrastate, interstate, or international basis. These recent advances have also enabled bankers to maintain better and more timely information on their operations and risk exposures, while creating a wider set of tools and instruments to address banking risks.

Overall, these changes have brought about the most innovative and revolutionary period in U.S. banking history. At the same time, they have led to many corresponding changes in banking regulation. Although the basic structure of the regulatory agencies has largely remained intact, a number of bank regulatory constraints have undergone significant change. As shown by the following events and regulatory changes, much of this period can be charac-

terized by an ongoing struggle by regulators, bankers, and policy-makers to strike an appropriate balance — a balance between allowing banks the flexibility to adapt to a rapidly changing environment and maintaining a regulatory framework that will ensure financial stability and adequate protection for bank customers.

Growth of bank holding companies

One of the first significant changes was the growth of bank holding companies, which are companies that hold stock in one or more banks and may have certain other ownership interests as well. Although such companies were first formed in the early 1900s, most of the growth in holding companies has been fairly recent. Outside of some mild restrictions in the Banking Acts of 1933 and 1935, the first time bank holding companies received much legislative attention was in the 1950s. Only a handful of banking organizations were ready to capitalize on the holding company structure then. Several of those organizations, though, were able to use holding companies to create sizeable interstate banking and nonbanking networks, thus circumventing branching and business restrictions imposed on banks.

This expansion prompted Congress to pass the Bank Holding Company Act in 1956, which placed the formation of multibank holding companies and their acquisition of banking and nonbanking interests under the control of the Federal Reserve. Under this act, bank holding companies could not acquire banks in other states unless specifically authorized by state law. Furthermore, any nonbanking activities of a bank holding company had to be closely related to the business of banking.

Congress did not extend the Bank Holding Company Act to companies owning a single bank in 1956, since such companies were generally small, local organizations. In the late 1960s, however, many large banks saw the one-bank holding company as a vehicle for expanding into financial services banks could not

legally perform, as well as a few nonfinancial activities far removed from banking. By the end of 1970, a third of all commercial banking deposits were controlled by one-bank holding companies. To place these companies under federal supervision and control their nonbanking activities, Congress amended the Bank Holding Company Act in 1970 to give the Federal Reserve System authority over the formation and operation of one-bank holding companies. The amendments also set public benefits standards for the approval of nonbanking activities and applied the same closely related to banking test to activities performed by one-bank holding companies.

With this regulatory framework in place, large bank holding companies continued to expand their banking and permissible nonbanking activities, thereby leading the way to significant consolidation in the banking industry. Small and medium-sized banks also began making greater use of the holding company structure. Much of this interest was prompted by a 1971 tax ruling. This ruling permitted stockholders of closely controlled bank holding companies to service bank acquisition indebtedness with tax-free dividends from the bank. In response to such factors, holding companies have become, by far, the most common form of bank ownership, with over 96 percent of all bank deposits under holding company control at year-end 1999.

With bank holding companies coming under federal supervision, Congress also sought to place decisions on bank expansion through mergers under the control of the regulatory authorities. The Bank Merger Acts of 1960 and 1966 gave the surviving bank's primary federal supervisor and the Department of Justice authority over bank mergers. To provide a consistent approach to holding company and merger decisions, Congress extended the same competitive and public benefits standards to both types of transactions.

Consumer protection

The next step in bank regulation originated with the consumer protection and social concerns that first became prominent in the 1960s and 1970s. At the federal level, legislation has included Truth in Lending, Equal Credit Opportunity, Fair Housing, Fair Credit Billing, Real Estate Settlement Procedures, Home Mortgage Disclosure, Community Reinvestment, and Truth in Savings. These laws were created to deal with many different facets of consumer banking services and transactions. The primary objectives behind consumer protection laws have been to ensure that financial customers receive equal treatment, consumer credit and deposit terms are disclosed accurately so the public can understand and compare financial products, and consumers are protected from abusive or deceptive practices. These concerns have been magnified by a very rapid expansion in the use of consumer credit since the 1970s. Not only has there been a vast expansion in the variety of consumer credit instruments and lenders, but such funding has also become available to many segments of the population that previously had little access to credit markets. In addition, other consumer laws and regulations have become necessary in order to keep up with recent technological advances that have created new ways of offering services to consumers.

Banking deregulation and other developments

Much of the regulatory and legislative change in banking during the late 1970s and early 1980s emphasized a more open, competitive banking environment and a more equal treatment of different types of financial institutions. This emphasis reflected the desire of bankers to take advantage of technological developments, meet the growing competition from other financial institutions and from foreign banking organizations, and adapt to a new eco-

conomic environment. Examples of legislation with this and other objectives include:

- *The International Banking Act of 1978*, which placed foreign and domestic banks on an equal footing in the United States with respect to branching, reserve requirements, and other regulations. The act also increased the ability of U.S. banks to compete in international banking.
- *The Financial Institutions Regulatory and Interest Rate Control Act of 1978*, which was aimed at preventing certain financial abuses, but also increased the ability of regulatory agencies to prevent undue concentrations of bank ownership and management through the Change in Bank Control Act and the Depository Institution Management Interlocks Act.
- *The Depository Institutions Deregulation and Monetary Control Act of 1980*, which sought to place various financial institutions on a more equal and efficient footing. This act equalized reserve requirements across all insured depository institutions; authorized automatic transfer services (ATS), negotiable orders of withdrawal (NOW), and share draft accounts nationwide; phased out interest ceilings on time and savings deposits; and broadened the investment and lending powers of savings and loan associations and savings banks. In addition, the act introduced explicit pricing of Federal Reserve services, made these services available to all depository institutions, and opened the Federal Reserve's credit facilities to any depository institution offering transaction accounts or nonpersonal time accounts.

Bank and thrift industry problems in the 1980s

Another focus of regulation and legislation during the remainder of the 1980s and the early 1990s was financial problems in the bank and thrift industries. Such problems began with high and fluctuating interest rates in the early 1980s and were magnified further by shortcomings in the thrift supervisory and insurance systems. Also playing a key role were sharp economic declines in the agricultural and energy sectors, many real estate markets, and a number of less developed countries with substantial borrowings from U.S. banks. The most severe problems occurred among thrifts, as numerous thrift insolvencies depleted the federal savings and loan insurance fund and necessitated substantial federal funding. In the banking industry, over 1,000 banks failed or required federal assistance during the 1980s, including several major banking organizations. These failures, along with the level of FDIC insurance reserves thought necessary to cover future failures, brought the bank insurance fund into a deficit position in the early 1990s.

As a result of such problems, much of the banking legislation during this period focused on dealing with troubled institutions and strengthening the regulatory framework. Among the bills with these objectives are:

- *The Garn-St Germain Depository Institutions Act of 1982*, which increased the ability of regulators to aid distressed institutions. This act further expanded the lending and investment powers of federal thrift institutions. Other provisions of the bill provided for a competitive deposit account at financial institutions and an increase in national bank lending limits to individual borrowers.
- *The International Lending Supervision Act of 1983*, which strengthened supervision and regulation of U.S. banks engaged in international lending and required

banks to maintain special reserves to address debt repayment problems in developing countries.

- *The Competitive Equality Banking Act of 1987*, which provided \$10.8 billion to recapitalize the thrift insurance fund, tightened several thrift and bank regulatory provisions, expanded emergency acquisition powers with regard to failing banks and thrifts, and reaffirmed that the full faith and credit of the United States backs insured deposits at banks and thrifts.
- *The Financial Institutions Reform, Recovery, and Enforcement Act of 1989*, which provided \$50 billion in funding for resolving failing thrifts. Other provisions established more stringent thrift capital and regulatory standards and created a new regulatory structure for thrifts with significant FDIC involvement. In addition, this act increased bank and thrift deposit insurance premiums, allowed bank holding companies to acquire any type of savings association, and expanded supervisory enforcement, conservatorship, and receivership powers over depository institutions.
- *The Federal Deposit Insurance Corporation Improvement Act of 1991*, which was passed to improve the supervision of banks and reduce or limit the cost of resolving failing institutions. This act required deposit insurance premiums to be set at levels sufficient to rebuild the fund. Other provisions of the act instituted a system of prompt corrective action, with mandatory and progressively more severe regulatory restrictions on banks that fail to meet specified capital levels. The act also contained provisions which limit the ability of problem institutions to borrow from the Federal

Reserve and require failing institutions to be resolved in the least costly manner except in systemic situations.

Modernizing the Financial System

The final series of legislative acts have largely concentrated on bringing banking regulation in step with a rapidly evolving financial system. Several industry trends are behind these recent regulatory changes. Among such trends are improved conditions in banking during the 1990s and the need to relax constraints imposed in more difficult times, substantial banking consolidation and interstate expansion, and the continued blending of banking and other segments of the financial industry. These financial industry developments are reflected in:

- *Riegle Community Development and Regulatory Improvement Act of 1994*, which authorized funding for community development projects in low- to moderate-income neighborhoods, but also contained a wide range of provisions to simplify or streamline the regulatory process and ease a number of regulatory constraints. These provisions included the simplification of bank reporting requirements, fewer examinations for small banks in sound condition, coordinated examinations for organizations supervised by more than one agency, and simplified notice requirements for certain acquisitions and transactions.
- *Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994*, which allowed bank holding companies to acquire banks in any state after September 29, 1995, and to merge banks located in different states into a single branch network after June 1, 1997, unless a state opted out of this branching authority. This leg-

isolation thus created a consistent, nationwide standard for interstate expansion, while allowing banking organizations to select the most efficient means for conducting interstate operations.

- *Economic Growth and Regulatory Paperwork Reduction Act of 1996*, which relaxed or eliminated a variety of regulatory provisions regarding application, approval, and reporting requirements.
- *Gramm-Leach-Bliley Act of 1999*, which was passed in order to allow affiliations among banks, securities firms, and insurance companies under a financial holding company structure. This act is an extremely important piece of legislation in that it removes many longstanding restrictions against such affiliations and thus sets the stage for dramatic changes within the financial industry. Other provisions of the act establish a regulatory framework under which bank, securities, and insurance regulators supervise their respective activities within a financial holding company, while the Federal Reserve serves as “umbrella supervisor” over the entire organization. The act also provides privacy safeguards for limiting disclosures of personal information, expands the number of institutions eligible for Federal Home Loan Bank System membership and advances, and provides for disclosure of Community Reinvestment Act (CRA) agreements and an extended CRA examination cycle for many smaller banks.

SUMMARY

The role and structure of U.S. banking regulation has changed drastically since the first bank charters were issued. Three federal

agencies have developed in response to banking problems, each with distinct powers and responsibilities. There have been overlaps in federal authority, and further regulatory overlaps have arisen as a result of dual banking, the presence of 50 state banking agencies, and the blending of banking with other financial services.

For over 65 years, this regulatory system has generally been successful in protecting depositors and ensuring banking stability. This record is notable, given previous experiences in U.S. banking, and should thus provide strong support for many current regulatory practices. Problems in the bank and thrift industries during the 1980s, however, demonstrate that this protection is not without cost or substantial risk. The current regulatory framework will be further tested as banks continue to develop new products and services and as the merging of banking with securities, insurance, and other financial activities proceeds. As a result, while much of the regulatory system is likely to remain in place, significant changes will occur as the banking industry continues to evolve.

CHAPTER 3

Banks, Bank Holding Companies, and Financial Holding Companies

The principal components of the U.S. banking system are banks, bank holding companies, and financial holding companies. The key role that banks have come to play in the financial system has been summarized in the previous chapters. In addition, bank holding companies have become a significant factor in recent years through their ownership of banks, additional financial activities by the parent company and nonbanking subsidiaries, and the ability of the holding company to attract funding for all of these operations. As a result of legislation passed in 1999, banking organizations may also operate as financial holding companies and conduct an even broader range of securities, insurance, and other financial activities. This chapter provides a closer look at what banks, bank holding companies, and financial holding companies are; how they are defined under the existing legal framework; and what powers or activities are authorized by law for each of these entities.

BANKS

According to size, commercial banks are the largest group of depository institutions in the United States, controlling over three-fourths of all deposits nationwide. Banks were the first type of depository institution in this country and have attained their present position by developing many financial services desired by the public. Throughout much of their history, banks could be distinguished from other financial institutions by the type of charter they were granted and the financial powers accompanying such charters. Even now, state and federal laws typically define banks by their charter and by the services they can offer.

All banks accepting deposits from the public must obtain a bank charter before they can open for business. Although the first bank charters in the United States were issued through special legislative acts, the present process involves a number of well-defined steps. To form a national bank, the organizing group must file an application with the Comptroller of the Currency. The Comptroller then reviews the application and, if all criteria are satisfied, issues the charter. Similar procedures exist at the state level with state banking commissioners, agencies, or boards of incorporation granting the charters for state banks. The specific criteria examined in the chartering process have changed over time and also will vary between state and federal authorities. However, the basic purpose remains the same — to assure that institutions accepting funds from the public are qualified and deserving of the public's trust.

Before beginning operations, national banks must obtain federal deposit insurance, and nearly every state has similar requirements for state banks. Banks seeking federal deposit insurance must apply to the Federal Deposit Insurance Corporation, and the FDIC must evaluate each request according to a number of statutory factors. Banks may also become members of the Federal Reserve System. State banks may choose whether to apply for membership, while national banks automatically become members once a charter is granted.

As a consequence of these chartering and related decisions, three principal categories of banks exist: national banks, state member banks, and state nonmember banks. Additionally, a number of other banks are sometimes listed as part of the banking system. Such banks include private banks, uninsured state banks, bankers' banks, trust companies, industrial banks, and certain savings banks.¹

The receipt of a charter entitles banks to engage in a number

¹ Since these institutions represent only a small part of the banking system and their regulatory framework is often unique, they will receive little attention in the following chapters.

of activities but also prohibits them from exercising other powers. These specific limitations can vary between national and state charters and from one state to another. National banks derive their basic powers from federal law, while state bank operations are primarily outlined in state statutes. This distinction, however, is not without exception. Where issues of national policy prevail, state banks must follow the relevant federal laws. Also, national banks may be subject to state statutes whenever federal law defers to state practices or when state laws do not place national banks at a disadvantage.

The general powers that national banks may exercise are outlined in section 8 of the National Bank Act of 1864:

. . . all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; by obtaining, issuing, and circulating notes according to the provisions of this act. . .²

Most state laws also grant broad deposit and lending authority to state banks. Although this authority is unique within each state, many of the banking powers granted by states are comparable to those for national banks.

State and national banks may accept several different categories of deposits, including demand deposits and other transaction accounts, time deposits, and savings deposits. These different deposit categories were developed by depository institutions in response to public needs, but have become further refined through legislative and regulatory actions. Demand deposits, for example, evolved out of the general deposit powers of banks and fulfilled the need for a more efficient and safer way to conduct larger transactions and transactions with distant parties. All categories of

² 12 U.S.C. §24.

deposits legally become liabilities of a bank and thus place the bank and the depositor in a debtor-creditor relationship.

Distinctions between the various types of deposits are now carefully defined for purposes of reserve requirements, transaction powers, and penalties for withdrawing funds before a specified maturity date. Demand deposits are generally defined as any deposit payable on demand. For reserve purposes, though, this definition also includes deposits with an original maturity or required notice period of less than seven days.³ A bank cannot pay interest on demand deposits. Banks are also required to maintain reserves, as specified by the Federal Reserve System, against their demand deposits and other transaction accounts.

Time deposits are deposits that are typically payable on a certain date or after a fixed period of time, and depositors are subject to penalties for funds withdrawn before this maturity date. Under federal regulations, a penalty is to be imposed on any withdrawals from a time deposit within six days after the deposit was made, although banks are free to impose other penalties on early deposit withdrawals. Savings deposit accounts have no prescribed maturity, but a bank can require at least seven days' notice before funds are withdrawn. Banks may also offer other accounts which are variations of their standard deposit offerings. These accounts include NOW (negotiable order of withdrawal) accounts and ATS (automatic transfer service) accounts with transaction powers, IRA (individual retirement account) deposits, MMDAs (money market deposit accounts) with limited checking powers, and public funds deposits that may be subject to securities pledging requirements of state and local governments.

Banks face few statutory restrictions on their lending activities, and these restrictions are based primarily on prudential factors rather than on the category of borrower. As a result, banks may

³ Prior to 1982, banks were the only institutions authorized to offer demand accounts, but subsequent federal legislation has extended limited demand deposit powers to federal thrift institutions.

lend funds to a wide variety of borrowers, including individuals, business concerns, farmers, real estate interests, financial institutions, and nonprofit groups. Most other depository institutions, in contrast, have historically been limited to certain types of loan customers or in the overall amount they may extend in a particular loan category.

The principal lending restrictions banks face are in the amount they may lend to any one borrower; to the bank's management, directors, and owners; or to organizations affiliated with the bank. Some banks are further constrained in the level of interest that can be charged on loans in certain states, in lending on a bank's own stock, and in the amount that can be extended on a particular real estate loan and on the total volume of such loans. In addition, since loans are an important factor in a bank's condition, supervisory personnel periodically review and evaluate all major lines of credit in a bank. Such reviews, along with the internal loan policies of a bank, further establish the types of lending appropriate for banks.

Other activities in which banks generally may engage include investing in and underwriting state, local, and U.S. Government securities; holding of investment grade securities; securities transactions for bank customers; leasing; trust services; insurance agency operations in small communities; and discounting of notes, drafts, or bills of exchange. Most of these activities are expressly authorized for national banks and, in some cases, for state banks. The current list of permissible bank securities activities was largely established in the Banking Acts of 1933 and 1935, although a number of legislative modifications have occurred since then. Under the Trust Powers Act of 1962, national banks may exercise fiduciary powers as long as such activities are authorized by state law for state-chartered banks, a special permit has been granted by the Comptroller of the Currency, and the bank segregates all assets held in a fiduciary capacity from its general assets and maintains separate records.⁴

⁴ 12 U.S.C. §92a.

National banks have also entered other activities under their incidental powers clause, and state banks have offered similar services when permitted.⁵ Some examples are letters of credit, loan sales, limited data processing services, credit-related insurance, and annuity sales as an agent.

In addition, the vast majority of states have “wild card” statutes that permit state-chartered banks to engage in any activity authorized for national banks. Some of these statutes only apply to a certain scope of activities, and many are implemented at the discretion of the state banking agency.

Some states have also authorized state banks to engage in an even broader range of activities in such areas as insurance sales and underwriting, real estate investment and development, and expanded debt and equity investment authority. In addition, a few states have adopted legislation allowing state banks to invest up to a given percentage of their assets in unspecified nonbanking activities. The ability of state banks to exercise many of these powers, however, is limited by federal statutes implemented in 1992, which generally restrict state banks to the same set of activities conducted by national banks. Activities beyond that may be undertaken only if the FDIC determines that they entail no significant risk to the deposit insurance fund and a bank is in compliance with capital standards.⁶

Banks may also establish operating subsidiaries, bank service corporations, and financial subsidiaries to engage in various bank-

⁵ The scope of the incidental powers clause for national banks has been the subject of considerable debate, and the courts have held that this clause allows activities beyond the enumerated powers of national banks, provided the activities are part of the business of banking (*NationsBank of North Carolina, N.A. v. Variable Life Annuity Co.*, 115 S.Ct. 810 (1995)). In ruling on incidental activities, the Comptroller of the Currency commonly cites three general principles derived from previous judicial decisions: is the activity functionally equivalent to or a logical outgrowth of a recognized banking activity, would the activity respond to customer needs or otherwise benefit the bank or its customers, and does the activity involve risks similar in nature to those already assumed by banks (*OCC Interpretative Letter No. 743*, October 17, 1996).

⁶ 12 U.S.C. §1831a, 12 CFR 362.

ing and financial activities. National banks and many state banks, for instance, may set up bank operating subsidiaries to engage in activities that are permissible for banks. Insured banks may also organize and hold the stock of bank service corporations, which can perform routine banking services such as check handling, as well as any nondeposit-taking service authorized for banks and any nonbanking, nondeposit-taking activity that the Federal Reserve has determined, by regulation, to be permissible for bank holding companies. Through financial subsidiaries, state and national banks may conduct an even broader set of financial activities, provided the bank and any depository institution affiliates are well capitalized and well managed and also have at least a satisfactory CRA rating at the time the activity is first undertaken. These activities must be “financial in nature or incidental to a financial activity” or activities that a bank can engage in directly.⁷ However, the activities may not include underwriting of noncredit-related insurance, issuing annuities, engaging in real estate investment or development, or conducting merchant banking operations.

In summary, banks have assumed an important role in the U.S. financial system through their deposit-taking, lending, and other activities. Although this combination of activities is no longer unique to the banking industry, banks still remain the major providers of many of these services.

BANK HOLDING COMPANIES

Bank holding companies are a form of bank ownership and provide an alternative to individuals directly owning bank stock. In general, a bank holding company is any company, corporation, or business entity that owns stock in a bank or controls the operation of a bank through other means. Individual investors may then hold stock in the parent holding company instead of directly

⁷ 12 U.S.C. §24a.

owning bank stock. Although this bank ownership role broadly defines bank holding companies, other functions are also important in describing these companies. For example, the holding company structure provides a means for acquiring additional banks or for expanding into a wider range of activities. Holding companies further offer a way of consolidating management and operations across these various interests.

Because of such functions, bank holding companies have become the dominant form of bank ownership over the last thirty years. At year-end 1999, 5,116 bank holding companies were in operation and controlled banks that held over 96 percent of total banking deposits in the United States. Moreover, holding companies are popular among all sizes of banking organizations. For large organizations, the principal benefits of holding companies are in the acquisition of additional banks, expansion into permissible nonbanking activities, better access to funds, and the consolidation of certain functions for more efficient operations. Smaller holding companies, on the other hand, are often formed because of consolidated tax benefits, control or estate planning considerations, or the need to provide additional services to local communities.⁸ As a result of widespread growth, bank holding companies greatly influence the structure of U.S. banking, the operation and management of banks, and the types of activities conducted by banking organizations.

The Bank Holding Company Act of 1956 and the 1970 amendments to this act establish the legal framework under which bank holding companies operate. In drafting the 1956 act, Congress had several purposes in mind, some of which were also reflected in the 1970 amendments:

⁸ Tax benefits for holding companies arise because the dividends received by the holding company from a subsidiary bank may be eliminated in computing consolidated taxable income. With individual ownership, however, bank dividends would be taxed at the stockholder's personal tax rate. The corporate tax benefit for closely held bank holding companies was made possible by Revenue Ruling 71-531 of the Internal Revenue Service.

- Control the creation and expansion of bank holding companies
- Separate bank holding companies' business of managing and controlling banks from unrelated [nonbanking] business
- Maintain competition among banks and minimize the danger inherent in concentration of economic power through centralized control of banks
- Subject bank holding companies to examination and regulation⁹

To accomplish these purposes, the Bank Holding Company Act of 1956 extended Federal Reserve regulation and supervision to companies that owned or controlled two or more banks. One-bank holding companies were brought under Federal Reserve supervision when Congress passed the 1970 amendments. Together these two pieces of legislation define bank holding companies and set the general standards for holding company formations, acquisition of additional banks, and expansion into nonbanking activities.

The act defines any company that has control over a bank as a bank holding company. A company is judged to control a bank if it: (a) directly or indirectly owns, controls, or has power to vote at least 25 percent of any class of the bank's voting stock; (b) controls in any manner the election of a majority of a bank's directors; or (c) is judged by the Federal Reserve Board to exert a controlling influence over bank management or policies through other means.¹⁰ The term company includes corporations, partnerships,

⁹ "Bank Holding Company Act," *House of Representatives Report No. 609*, 84th Congress, 1st Session.

¹⁰ Companies with less than 5 percent voting stock ownership are presumed not to have control over a bank. Also a few companies are excluded from the act, such as a company that temporarily acquires control of a bank through collection on a debt in which the bank's stock was held as collateral or was otherwise used to discharge the obligation.

associations, or long-term trusts, but does not extend to bank ownership by individuals. With certain exceptions, the provisions of the act apply to the ownership of banks that have FDIC insurance and other institutions that both offer transaction accounts and make commercial loans.¹¹

Before a company can become a bank holding company or acquire additional banks, it must apply to the Federal Reserve System and receive approval for its proposal. The Federal Reserve, in deciding upon such applications, must evaluate the competitive effects of any proposal. Other factors the Federal Reserve must consider are “the financial and managerial resources and future prospects of the company or companies and the banks concerned, and the convenience and needs of the community to be served.”¹²

Bank holding company formations and bank acquisitions must also be consistent with state law. For example, the laws of a particular state may set limits on the share of total deposits in a state that a banking organization may acquire and whether banking organizations may acquire newly chartered banks or only banks already in existence.¹³ As a result, state laws often play an important role in a holding company’s expansion within its home state and across state lines.

To separate banking from unrelated nonbanking activities, the Bank Holding Company Act prohibits holding companies from owning or controlling nonbanking interests except under certain circumstances. The most important exception to this prohibition is for activities the Federal Reserve Board determines “to be so closely related to banking or managing or controlling banks as to

¹¹ 12 U.S.C. §1841(c). The definition of bank in the act, as amended in 1987, does not include thrift institutions that have federal charters or membership in the Savings Association Insurance Fund.

¹² 12 U.S.C. §1842(c).

¹³ Provisions of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, for example, would prevent a company from making further acquisitions in a state once it controls 30 percent of the insured deposits in the state. However, individual states may override this limit in either direction with an alternative deposit cap.

be a proper incident thereto.” In implementing this standard, the Board has constructed a list of permissible nonbanking activities and has approved other activities on a case-by-case basis.¹⁴ The Gramm-Leach-Bliley Act of 1999, however, puts a “freeze” on new nonbanking activities for holding companies that do not elect to become financial holding companies. As a result, banking organizations that continue as traditional bank holding companies must restrict themselves to nonbanking activities that the Federal Reserve Board had placed on the list of permissible activities or approved by order at the time this legislation was passed.

To engage in a nonbanking activity, a bank holding company must file a notice with the Federal Reserve. Examples of nonbanking activities conducted by bank holding companies are credit-related insurance; mortgage banking; leasing; operation of savings associations, consumer finance companies, and industrial banks; securities brokerage and limited underwriting activities; and data processing services of a financial, banking, or economic nature for other parties.

Once a holding company receives approval for formation or expansion, its subsequent operations must comply with certain provisions of the Bank Holding Company Act and other applicable banking laws. In particular, the Bank Holding Company Act gives the Federal Reserve System authority to examine bank holding companies and, with some limitations, their subsidiaries. These examinations may be made in order to monitor compliance with the act, assess the operations and condition of a company, and identify any risks the company might pose to its subsidiary banks. Under this authority, the Federal Reserve periodically inspects bank holding companies, focusing on any company relationships or practices that could be detrimental to subsidiary banks. Key components of these inspections therefore include the

¹⁴ These permissible nonbanking activities for bank holding companies are listed in Table 8, page 156 of this book.

condition of the parent organization and its subsidiaries, inter-company transactions and relationships, holding company debt and the potential demands it places on subsidiary bank earnings, and compliance with applicable laws and regulations.

In addition, amendments to the Bank Holding Company Act generally prohibit holding companies from requiring the customers of a subsidiary bank to purchase additional services from any subsidiary of the company. Other banking laws further limit the amount and type of transactions between a subsidiary bank and certain other holding company affiliates.

FINANCIAL HOLDING COMPANIES

A new form of bank holding company — the financial holding company — became possible after passage of the Gramm-Leach-Bliley Act of 1999. Compared to traditional bank holding companies, financial holding companies may take advantage of a much broader range of affiliations among banks, securities firms, and insurance companies, provided these organizations can meet and continue to comply with a new set of regulatory standards. As a result, financial holding companies provide an opportunity for a dramatic restructuring of many aspects of our financial markets.

To become a financial holding company, a bank holding company must file a written declaration with the Federal Reserve Board stating that it elects to be a financial holding company. In its declaration, a company must certify that the depository institutions it controls are all well capitalized and well managed. The well-capitalized standard is the same as the one the federal banking agencies specify under their capital adequacy regulations and guidelines.¹⁵ To be considered well managed, an institution must have achieved at least a satisfactory management rating at its most

¹⁵ This capital standard is presented in Table 5, on page 91 of this book.

recent examination.¹⁶ Also, before an organization can become a financial holding company, all of its insured depository institutions must have achieved at least a satisfactory rating on their most recent CRA examinations.

Once an organization becomes a financial holding company, it is not only authorized to conduct all activities permissible for bank holding companies but may also engage in a number of other financial activities. For instance, financial holding companies can engage in any activity that the Federal Reserve Board, in consultation with the Secretary of the Treasury, determines “to be financial in nature or incidental to such financial activity; or is complementary to a financial activity and does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally.”¹⁷ Among the financial activities specifically authorized in the legislation are securities underwriting, distributing, and dealing; insurance agency and underwriting activities; and merchant banking.¹⁸

Financial holding companies must follow the same approval procedures and standards as traditional bank holding companies when acquiring banks and other depository institutions. For financial activities authorized in the 1999 legislation, financial holding companies only have to notify the Federal Reserve Board within 30 days after commencing the activity or acquiring a company engaged in that activity. Companies must submit a written request if they wish to have the Board and the Secretary of the Treasury determine that a particular activity is financial in nature or incidental to a financial activity. Prior Board approval must be

¹⁶ This examination rating system is described on pages 117–22 of this book.

¹⁷ 12 U.S.C. §1843(k).

¹⁸ Merchant banking commonly entails making substantial investments in companies, which will only be held for a period long enough to allow the sale or disposition of each investment at an anticipated profit. Merchant bankers do not directly manage the companies in which they invest, but they might help in setting general strategies and structuring the companies for resale.

obtained for any activity that a company believes to be complementary to a financial activity.

After a financial holding company begins operations, the capital, managerial, and CRA provisions that it initially had to satisfy still remain important. If a depository institution in a financial holding company fails to meet the well-capitalized and well-managed standards, the company will face corrective supervisory action and will not be able to take on new financial activities. Moreover, companies that do not correct such deficiencies within 180 days may be forced to either divest their depository institutions or terminate any newly authorized financial activities. For organizations with one or more depository institutions that fail to maintain satisfactory CRA ratings, the regulatory penalty is a prohibition against taking on new financial activities.

The Gramm-Leach-Bliley Act of 1999 also establishes a streamlined framework for the ongoing supervision of bank holding companies and financial holding companies. This framework relies heavily on the concept of “functional regulation,” under which similar activities are to be regulated by a single regulator with expertise in that area. Under this act, the Federal Reserve System continues to serve as the supervisor of all bank holding companies, including financial holding companies, with general authority to examine and require reports from holding companies and their subsidiaries. However, the supervisory steps the Federal Reserve may take are limited with regard to holding company subsidiaries supervised by other authorities.

The 1999 legislation requires the Federal Reserve to use, “to the fullest extent possible,” the reports and examinations of other regulators, including appropriate state and federal authorities for banks and thrifts; the Securities and Exchange Commission for registered securities brokers, dealers, or investment advisers; and state insurance commissioners for licensed insurance companies. The Federal Reserve may examine a financial subsidiary regulated by another authority only under certain conditions: (1) the subsidiary is

believed to be engaged in activities posing a material risk to affiliated depository institutions, (2) an examination is necessary to assess risk management systems, or (3) there is reasonable cause to believe a subsidiary is not in compliance with the Bank Holding Company Act or other laws enforced by the Federal Reserve. In addition, the Federal Reserve may not set capital requirements for functionally regulated subsidiaries that are already in compliance with the capital standards of their primary supervisor. Neither may the Federal Reserve require such subsidiaries to assist affiliated depository institutions if that would materially harm their own condition.

Financial holding companies thus represent a significant development in U.S. financial markets — the removal of many long-standing barriers to affiliations among banks, securities firms, and insurance companies. In fact, this new framework permits holding companies to offer a combination of services not previously possible, and to do so under the general oversight of the Federal Reserve, coupled with functional regulation of the individual activities.

CHAPTER 4

Regulatory Agencies

The presence of both federal and state authorities has brought almost all banks under the regulatory authority of more than one agency. All banks fall under the supervision and regulation of their chartering authority, at either the state or federal level. If deposit insurance is obtained — as it virtually always is — a bank is subject to certain statutes of the Federal Deposit Insurance Act and, in the case of state nonmember banks, to direct FDIC supervision. If a state bank becomes a member of the Federal Reserve System, the Federal Reserve is its primary federal supervisor. Also, formation of a bank holding company or a financial holding company subjects banks and banking organizations to an additional layer of regulation and supervision at the parent company level. Moreover, banking organizations may further be subject to the oversight of insurance, securities, or other regulators as they take on nonbanking activities. Table 1 summarizes supervisory relationships and the bank regulatory structure.

Regulatory agencies not only supervise the internal operations of commercial banks, but also make decisions affecting the number of banks, their ability to expand, and their permissible activities. This chapter describes the agencies responsible for making these decisions and administering state and federal banking laws.

COMPTROLLER OF THE CURRENCY

The Office of the Comptroller of the Currency is the oldest of the federal bank regulatory agencies. Established by the National

TABLE 1
The Present Bank Regulatory Structure

	<u>NATIONAL BANKS</u>		<u>MEMBERS OF THE FEDERAL RESERVE SYSTEM</u>	<u>INSURED NONMEMBERS</u>	<u>UNINSURED</u>
CHARTERING AUTHORITY	Comptroller of the Currency	_____	State Banking Department	_____	
SUPERVISORY AND EXAMINING AUTHORITY	Comptroller of the Currency	_____	State Banking Department and Federal Reserve System	_____	_____
FDIC INSURANCE		_____	Upon FDIC approval	_____	
FEDERAL RESERVE MEMBERSHIP	Automatic with charter		Upon Federal Reserve approval		
APPROVAL FOR BRANCH APPLICATIONS	Comptroller of the Currency	_____	State Banking Department and Federal Reserve System	_____	_____
APPROVAL FOR BANK MERGERS ^{1, 2}	Comptroller of the Currency	_____	State Banking Department and Federal Reserve System	_____	_____
APPROVAL OF BANK HOLDING COMPANY FORMATIONS AND ACQUISITIONS ^{2, 3}		_____	Federal Reserve System	_____	
FINANCIAL HOLDING COMPANY CERTIFICATION AND PRIOR NOTICE OF NEW ACTIVITIES		_____	Federal Reserve System	_____	

¹ If the bank resulting from a merger is insured, the responsible federal agency also requests reports on the competitive effects from the Department of Justice and the other two federal banking agencies. The two banking agencies are not required to file these reports if the merger does not raise competitive issues.

² Between the approval and consummation dates of a bank merger or a bank holding company acquisition involving a bank, the Department of Justice may bring action under the antitrust laws.

³ The Federal Reserve Board is required to notify and solicit the views of the Comptroller of the Currency on proposed holding company acquisitions of national banks and the appropriate state banking department on the proposed acquisition of a state bank. When the Federal Reserve sends the notification letters, a copy is commonly sent to the FDIC. Any uninsured bank becoming a subsidiary of a holding company must obtain federal deposit insurance.

TABLE 2
Commercial Banks in the United States

(All figures are as of year-end 1999)

	Number of <u>banks</u>	Percent of <u>all banks</u>	Total deposits* <u>(\$ in billions)</u>	Percent of <u>total deposits</u>
National banks	2,368	27.6	\$1,776.2	55.9
All state banks	6,209	72.4	1,398.5	44.1
State member banks	1,010	11.8	636.7	20.1
State nonmember banks	5,199	60.6	761.8	24.0
All U.S. banks	8,577	100.0	\$3,174.7	100.0

*Total deposits are based on deposits held in the domestic offices of U.S. banks and do not include deposits held in the foreign offices of these banks.

Currency Act of 1863 and strengthened by the National Bank Act of 1864, the Comptroller is the primary supervisory agency for national banks. As shown in Table 2, there were 2,368 national banks at the end of 1999. That was more than 27 percent of the commercial banks in the United States. National banks held \$1,776 billion in deposits in their U.S. offices, which was nearly 56 percent of all bank deposits nationwide.

The Comptroller is a bureau of the Treasury Department and is headed by a single person appointed by the President to a five-year term. In addition to its headquarters in Washington, D.C., the Comptroller has six district offices.

The Comptroller exercises control over the operations of national banks through a variety of means. These include the power to charter national banks, review national bank branch and merger applications, implement regulations, and examine and supervise all national banks. As a result, the Comptroller not only plays an oversight role with respect to national bank operations, but also influences the chartering and expansion of national banks through various policy decisions. In addition, the Comptroller of the Currency serves as a director of the FDIC.

To assure compliance with its supervisory policies and regula-

tions, the Comptroller can issue cease and desist orders, remove or suspend bank officials and other parties affiliated with a national bank, and place national banks into conservatorship or revoke their charters. The Comptroller can also fine national bank officers, directors, employees, or other affiliated parties for such offenses as violating banking laws and regulations and engaging in unsafe or unsound practices.

FEDERAL RESERVE SYSTEM

Established in 1913 by the Federal Reserve Act, the Federal Reserve System is headed by a seven-member Board of Governors, appointed by the President to 14-year terms. One governor is designated by the President as chairman with a four-year, renewable term.

In addition to the Board of Governors headquartered in Washington, D.C., the Federal Reserve System consists of 12 Federal Reserve banks and 25 branches located throughout the country. Each Federal Reserve bank has a board of nine directors, six elected by member banks and three appointed by the Board of Governors. Of the directors elected by member banks, three represent member banks and three come from the business community. The three directors appointed by the Board of Governors are selected to represent the public.

The Federal Reserve System directly supervises state-chartered banks that choose to become members. There were 1,010 state member banks at year-end 1999 (See Table 2). These represented almost 12 percent of the total number of commercial banks, and they held over \$636 billion in deposits, which was more than 20 percent of the nation's commercial bank deposits. In addition to its bank supervisory responsibilities, the Federal Reserve reviews membership applications from state banks and, in conjunction with state authorities, merger and branching proposals from state member banks.

The Federal Reserve is also the primary supervisor and regula-

tor of bank holding companies and financial holding companies. For these companies, the Federal Reserve either reviews or receives notification of their formation and expansion proposals and is also responsible for supervising the overall banking organization. As a result of supervising holding companies, the Federal Reserve gains an insight into the operations of many banks not directly under its supervision. At year-end 1999, 5,116 bank holding companies were in operation, with control of 6,764 subsidiary banks. These banks held over 96 percent of the total deposits in all U.S. commercial banks. As of October 20, 2000, a total of 435 banking organizations had elected to become financial holding companies.

The Federal Reserve has a number of powers to enforce its supervisory policies and regulations. These powers include the authority to issue cease and desist orders, remove bank and holding company officers and other affiliated parties, levy fines, revoke membership, and order divestiture or termination of financial holding company activities.

The Federal Reserve also has other public policy responsibilities. Foremost, it conducts monetary policy through open market operations and adjustments in the discount rate and reserve requirements. It acts as the fiscal agent for the federal government and provides services like check collection, currency and coin distribution, and fund transfers.

FEDERAL DEPOSIT INSURANCE CORPORATION

Established by the Banking Act of 1933, the Federal Deposit Insurance Corporation directly supervises and examines insured state-chartered banks that are not members of the Federal Reserve System. There were 5,199 insured, state nonmember banks at year-end 1999, accounting for over 60 percent of the nation's commercial banks (See Table 2). These banks held over \$761 billion in deposits, or about 24 percent of U.S. bank deposits.

Like the Federal Reserve, the FDIC is an independent federal

agency. It is managed by five directors, one of whom is the Comptroller of the Currency, another is the director of the Office of Thrift Supervision, and three others are appointed by the President for a term of six years. One of the appointed members is designated by the President as chairman of the FDIC for a five-year term. The main office is in Washington, D.C., and the FDIC has eight regional supervisory offices.

Although the FDIC supervises a large number of banks, its main function is to insure deposits at commercial banks and thrift institutions. Before a bank can obtain deposit insurance, it must apply to the FDIC and receive approval. FDIC insurance responsibilities also extend to protecting insured depositors, acting as receiver for failed banks, and administering the deposit insurance funds. The bank insurance fund is financed through assessments on insured banks. The fund reported a balance of \$29.4 billion at the end of 1999 — a substantial increase from the early 1990s when the FDIC reported a deficit in the fund. This balance is equal to 1.36 percent of total insured deposits.

The FDIC is authorized to make special examinations of any insured bank when it is necessary to determine the condition of the bank for insurance purposes. Since 1983, for example, the FDIC has participated in the examination of certain problem banks not directly under its supervision. In order to eliminate redundant examinations, the FDIC's current policy is to participate in the examination of banks supervised by other agencies only when the examinations represent a concurrent effort or are confined to special circumstances.

The FDIC has a variety of enforcement powers to carry out its bank supervisory and deposit insurance responsibilities. These powers include the ability to terminate deposit insurance at insured institutions and to issue cease and desist orders, remove bank officials and other affiliated parties, and levy fines at state nonmember banks. The FDIC may also recommend or pursue enforcement actions against other insured depository institutions

and may appoint itself as conservator or receiver of an insured depository institution when deemed necessary to reduce the risk of insurance fund losses.

In addition to its banking responsibilities, the FDIC gained authority in 1989 to insure thrifts through the Savings Association Insurance Fund. The FDIC may undertake special examinations of insured thrifts for deposit insurance purposes. The FDIC can also prevent thrifts from pursuing activities or actions that would pose a serious threat to the insurance fund. Apart from these insurance powers, the FDIC supervises state-chartered savings banks.

FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL

To promote consistency in the examination and supervision of financial institutions, the Financial Institutions Regulatory and Interest Rate Control Act of 1978 created the Federal Financial Institutions Examination Council. The council is composed of the Comptroller of the Currency, one governor of the Federal Reserve System, the director of the Office of Thrift Supervision, and the chairmen of the FDIC and National Credit Union Administration Board. The council's primary assignment is to "establish uniform principles and standards and report forms for the examination of financial institutions."¹ It also makes recommendations on matters of common concern to supervisors, conducts schools for examiners and training seminars on risk management, and periodically meets with a liaison committee composed of five representatives from state financial regulatory agencies.

¹ Financial Institutions Regulatory and Interest Rate Control Act of 1978, Section 1006(a). 12 U.S.C. §3305(a). The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 established another group, the Credit Standards Advisory Committee, to review and monitor credit standards and lending practices of insured depository institutions, as well as the federal supervision of these standards and practices. This committee is composed of six public members and one representative from each of the five federal agencies supervising depository institutions.

Other responsibilities of the council include helping maintain uniformity among federal banking agencies in identifying problem institutions and in classifying loans that involve country risk or are large credits shared by several different banks. As directed by Congress in 1989, the council also monitors the real estate appraisal requirements established by federal regulatory agencies and the appraiser certification and licensing standards of each state.

Agencies represented on the council maintain their independence in most areas. As a result, while the council has achieved more consistency in dealing with supervisory issues and reporting forms, its recommendations have not always been adopted uniformly.

STATE BANKING AGENCIES

Every state maintains its own regulatory agency to charter and supervise state banks. The organizational features of these agencies vary from state to state. In many states, the agency supervising state banks also supervises other types of financial institutions.

Banks chartered by the state must follow all applicable state laws and regulations. In addition, if a state bank takes out federal deposit insurance or chooses membership in the Federal Reserve, it also must comply with the appropriate federal regulations, even though some state statutes may be more lenient. Although state supervisory policies vary from state to state, the Conference of State Bank Supervisors provides a forum for discussing issues of common interest to all state regulators. It further assists states in maintaining efficient and effective banking departments.

There were 6,209 insured, state-chartered banks at the end of 1999 (See Table 2). These banks held \$1,398 billion in domestic deposits, which was more than 44 percent of the deposits of commercial banks nationwide.

State regulatory agencies issue bank charters, conduct bank examinations, construct and enforce bank regulations, and rule on proposed branch and merger applications. To enforce regulatory

policies, they can impose a number of sanctions. All states empower their regulatory agencies to revoke a state bank's charter for unsound banking practices, and many state agencies can also issue cease and desist orders, remove bank officials, and levy fines.

OTHER REGULATORY AGENCIES

Other state and federal agencies also have a role in the regulation of commercial banks and banking organizations. In most cases, these regulators have come to have jurisdiction over banks as a result of the changing structure of banking, an expanding range of bank and holding company activities, and concern for consumer protection. Several of the more important agencies are the Justice Department, the Securities and Exchange Commission, the Office of Thrift Supervision and other thrift regulators, state insurance commissioners, and the Federal Trade Commission.

Department of Justice

The Justice Department's antitrust division is one of the authorities responsible for enforcing federal antitrust laws. Many bankers and federal bank regulators once believed that commercial banks were exempt from antitrust laws. However, in 1963, the Supreme Court clearly ruled in *United States v. Philadelphia National Bank* that banking does not have an exemption.² This decision, along with the Bank Merger Acts of 1960 and 1966 and the Bank Holding Company Act of 1956, gives the antitrust division authority to challenge bank mergers and acquisitions.

The Justice Department can review the potential competitive effects of any bank merger or holding company consolidation or acquisition of banks. Under the Bank Merger Acts, the primary federal supervisory agency reviewing a proposed bank merger is

² 374 U.S. 321, 83 S.Ct. 1715 (1963).

required to seek an advisory opinion from the Justice Department concerning any probable competitive effects and to notify the Justice Department if approval is granted. Under the Bank Holding Company Act, the Federal Reserve is required to notify the Justice Department immediately when it grants a bank holding company approval to acquire a bank or merge with another holding company. If the Justice Department wants to challenge a proposed acquisition or merger, it must take action under federal antitrust laws within 30 days after approval and before the acquisition is consummated.

Securities and Exchange Commission

The Securities and Exchange Commission (SEC) was established in 1934 to regulate practices in the securities industry. The SEC is headquartered in Washington, D.C., and is run by five presidentially appointed commissioners. Banks and banking organizations are subject to SEC regulations and oversight in a number of areas. First, many larger bank holding companies must follow SEC registration and reporting requirements when they publicly issue stock, have stock traded on major exchanges, or make tender offers. The SEC has also become involved in such areas as the accuracy of bank loan loss reserves and other financial disclosures, accounting and disclosure rules on insider loans, the appropriateness of insider stock trading, and bank mutual fund and securitization activities.

In addition, the SEC serves as the primary regulator for activities conducted in a securities subsidiary of a bank or a holding company. Banks, though, can avoid registering as brokers or dealers and coming under direct SEC supervision if they limit their securities operations to the list of activities exempted by the Gramm-Leach-Bliley Act of 1999. Depending on the particular activity, the securities operations of banking organizations may also be regulated by other authorities, including the National Association of Securities Dealers, Commodity Futures Trading Com-

mission, Municipal Securities Rulemaking Board, and various securities exchanges.

Office of Thrift Supervision and other Thrift Regulators

When banking organizations acquire and operate thrift institutions, the resulting activities will be under the oversight of one or more thrift regulators. The main thrift regulator, the Office of Thrift Supervision (OTS), is responsible for chartering, supervising, and regulating federal savings associations and federal savings banks. In addition, the OTS shares with state agencies supervisory and regulatory authority over state-chartered savings associations belonging to the Savings Association Insurance Fund. It also regulates savings association affiliates and thrift holding companies.

The OTS is a bureau of the Treasury Department and is headquartered in Washington, D.C. It is headed by a director, who is appointed by the President to a five-year term. This director also serves on the FDIC Board. The OTS has five regional offices.

State savings associations and state savings banks are chartered by state thrift regulators. These regulators also examine and supervise all state-chartered thrifts — an authority they share with either the OTS or the FDIC whenever the thrifts obtain federal insurance.

State Insurance Commissioners

State insurance commissioners play a key role in regulating the insurance activities of banks and bank affiliates. Each state has an insurance commissioner or insurance department. This regulatory framework is further supported by the McCarran Ferguson Act, under which Congress granted individual states and their insurance commissioners the general authority to regulate insurance activities. Consequently, banks and bank affiliates that wish to engage in insurance activities must comply with state licensing

laws and other state insurance laws and regulations, provided these provisions do not discriminate against banking organizations.³

In the Gramm-Leach-Bliley Act, Congress provided a framework for creating greater uniformity in state insurance agent and broker licensing laws. The act provides a three-year period for the majority of states to establish uniform or reciprocal licensing laws. If such uniformity is not achieved, then a National Association of Registered Agents and Brokers would be created. This private, non-profit entity would have authority to establish uniform criteria for the qualification, training, and continuing education of insurance agents and brokers.

Federal Trade Commission

The Federal Trade Commission, which investigates business practices that deceive or mislead consumers, shares with other federal regulatory agencies responsibility for the enforcement of the Truth in Lending Act and other consumer protection legislation. The FTC's enforcement responsibilities under these acts are confined primarily to nondepository lending institutions. The commission's rule-making powers are limited to its own enforcement procedures for these acts.

³ The Gramm-Leach-Bliley Act, for instance, provides for federal preemption of state insurance laws that would discriminate against banks or otherwise prevent or significantly interfere with bank insurance sales, solicitations, or cross-marketing activities. The act, however, expressly allows states to impose 13 specific "safe harbor" restrictions on bank insurance activities, and these restrictions cannot be preempted under the circumstances listed above.

CHAPTER 5

Regulation for Depositor Protection and Monetary Stability

Depositor protection and monetary stability can depend on many factors other than the deposit activities of banks. Few of the assets backing bank deposits, for instance, can be considered riskless, and virtually all bank operations entail some potential exposure to loss. In addition, since a notable portion of bank deposits are available on demand, bank liquidity can be an important factor in maintaining depositor confidence. Given these complexities, it is not too surprising that several different approaches are commonly used to protect depositors. These include restrictions on bank risk taking, a deposit insurance system funded through premiums paid by banks, and the federal government's assumption of overall responsibility for monetary stability and depositor protection.

Historically, much of the regulatory effort in the United States has been directed toward controlling the overall risk that banks incur. Banking regulators first sought to restrict bank risk taking as a means of limiting individual bank failures and depositor losses, as well as preventing banking panics. With the advent of deposit insurance, control of banking risks also became a way of limiting claims on the deposit insurance fund and thus making deposit insurance a workable system. Some of the methods now used by bank regulators to control banking risks are bank capital requirements, restrictions on the type and quality of bank securities holdings, periodic examinations of loan quality and other banking factors, limitations on the activities that banks and their employees can pursue, and supervisory enforcement actions to control risk taking at problem institutions.

These efforts to control banking risk are an essential element in today's banking system and in the protection of depositors. Such controls must be sufficient to limit bank risk taking to a level consistent with depositor interests, overall financial stability, and the continued operation of the deposit insurance system. At the same time, though, this regulatory approach must not be too restrictive if banks are to meet the needs of their customers, compete effectively with other financial institutions, and adapt to a changing financial system. Banks, in fact, cannot avoid taking risks in their everyday operations. They must design services in anticipation of both customer needs and economic trends, make decisions on the creditworthiness of borrowers and their ability to repay debts in the future, and enter into many complex financial transactions. As a result, regulatory controls on bank risk taking must establish prudential bounds on banking activities without needlessly restricting normal banking functions.

Federal deposit insurance provides an additional means of protecting depositors. By separating the fate of depositors from that of their banks, deposit insurance has prevented panic withdrawals and widespread banking collapses. It has also created a way to resolve serious banking problems without adversely affecting bank customers or other banks in the area. In many cases, for instance, bank regulators have been successful in finding buyers or merger partners for failing banks, thus preserving banking service to communities and maintaining confidence in the banking system. Deposit insurance, though, has not been without costs—either in terms of the potential exposure it places on the federal government and taxpayers or the perverse incentives it may create by limiting the need for depositors to pick the safest banks.

A final link in the system of depositor protection is the federal government itself. Economic and monetary stabilization policies have helped to avoid any repeat of the economic collapse of the 1920s and 1930s. Furthermore, the implicit federal backing to the

deposit insurance system has given depositors an assurance of safety, even in the event of a crisis that might exhaust the insurance fund.¹

In reviewing bank regulation for depositor protection, this chapter focuses first on the activities in a bank that influence the risk of its operations and the exposure faced by depositors or by insurers of deposit safety. These activities are examined with regard to the specific regulations and guidelines imposed to protect depositors and the supervisory methods adopted to ensure regulatory compliance and assess risk. The second part of the chapter discusses supervisory procedures from an operational standpoint. It also covers the methodology used to combine all of the individual risk factors at a bank into an overall assessment of the bank and the safety of its depositors.

BANKING FACTORS AND REGULATIONS AFFECTING DEPOSITOR SAFETY

The role bank regulators assume in protecting and insuring depositors is similar to the position any creditor or insurer takes in protecting his or her interests. A bank regulator has much the same concerns as any creditor and takes much the same steps. Creditors try, for example, to limit a borrower's risk or charge more for higher risks. Creditors also try to limit their own exposure and increase a borrower's stake in the transaction by securing collateral for the loans they make and by limiting a borrower's indebtedness relative to his or her income and resources. A creditor may also want to impose restrictions on a borrower's activities and use of assets and undertake periodic investigations of the borrower's operations.

Bank regulators take many similar steps in an effort to control

¹ A 1982 concurrent resolution of Congress reaffirmed that insured deposits are backed by the full faith and credit of the United States. This full faith and credit backing was also included in Title IX of the Competitive Equality Banking Act of 1987 and in the insurance sign that savings associations must display in accordance with the Financial Institutions Reform, Recovery, and Enforcement Act of 1989.

banking risks and thereby protect depositors and ensure financial stability. Banks, for instance, are restricted to certain activities and must maintain adequate capital relative to asset and operational risks. They are also expected to maintain enough low-risk liquid securities to cover normal fluctuations in deposits. They are regularly examined, and bank supervisors will impose tighter restrictions on banks if their condition declines.

Several other regulations, such as bank entry restrictions and supervisory review of ownership and management changes, affect depositors and banking risks. However, since these regulations have a substantial effect on banking competition and efficiency, they are discussed in the next chapter.

General lending and investment restrictions

In our fractional reserve banking system, loans and securities represent the major assets supporting a bank's deposit liabilities. For that reason, depositor protection and the stability of the banking system are closely tied to the quality and liquidity of these two asset items, and a number of regulatory and supervisory standards address the types and quality of assets banks can hold. This policy is implemented in two ways. First, state and federal statutes define permissible banking assets. Second, regular examinations and other supervisory procedures are used both to check compliance with the statutes and to review a bank's loan and investment policies and the quality of its assets.

There are relatively few statutory restrictions which limit the specific types of loans a bank can make. In this respect, banks have been somewhat unique among financial institutions in their role as a lender for all purposes and to many kinds of customers. Although bankers must follow any state and federal credit statutes applying to lenders in general, only a few provisions restrict the types of loans they can make. Instead, bank credit decisions are based primarily on business factors and the need to maintain a

secure asset base and a sound reputation in order to support bank deposits. Periodic loan reviews by internal committees, independent auditors, and bank supervisors provide an additional check on bank credit quality.

Real estate loan restrictions — Historically, one of the few areas of bank lending that has drawn special legislative and regulatory attention is real estate lending. Restrictions on bank real estate lending have varied from an outright prohibition on such lending in the early days of the national banking system to relatively minor restraints in some recent periods. Limits on real estate lending were implemented originally to keep banks from carrying a concentration of long-term loans that could not be readily liquidated to meet depositor needs or quell a banking crisis. These limits further sought to control the credit and interest rate risks inherent in many aspects of real estate lending. Regulations, though, were gradually eased as banking stability increased and a better secondary market for mortgage loans developed. Public interest in the promotion of home construction and ownership also played a part in this change.

Current real estate lending regulations attempt to limit excessively risky lending practices, while giving bankers flexibility to meet the needs of most borrowers. These regulations are also a response to real estate problems over the last four decades and were mandated by section 304 of the Federal Deposit Insurance Corporation Improvement Act of 1991.²

The real estate provisions, as implemented by the three federal banking agencies and the Office of Thrift Supervision, first require each insured depository institution to establish and maintain comprehensive written policies for real estate lending. In these policies, banks are required to address a number of considerations. The policies, for instance, should establish standards for loan portfolio

² For national banks, state nonmember banks, and state member banks, the real estate lending regulations can be found in 12 CFR 34 Subpart D, 12 CFR 365, and 12 CFR 208 Subpart E, respectively, and the Interagency Guidelines for Real Estate Lending Policies are contained in the appendices to these parts.

diversification, with limits on the volume of lending in various real estate categories and within a geographic market.

Other policy provisions should set prudent underwriting standards for a bank, including the specific criteria that will be used to judge creditworthiness. These provisions should also indicate maximum loan maturities, acceptable amortization schedules for each type of loan, and the maximum loan amount that generally can be extended in relation to the market value of the property. Bank real estate lending policies should further incorporate loan administration procedures that encompass the documentation of a borrower's condition, periodic evaluations of collateral, and all steps from closing the loan through payoff or collection on it. A final policy topic should be the requirements the bank has in place for monitoring compliance with its real estate lending policies.

In addition, federal regulations provide specific guidance on the appropriate level of real estate lending in relation to the value of the property that is held as collateral. While institutions are free to establish their own internal loan-to-value limits for real estate lending, these limits should not exceed the supervisory limits which are shown in Table 3. Banks, however, may make or purchase real estate loans that exceed the supervisory loan-to-value guidelines, provided this lending is supported by individual credit factors. The aggregate amount of such loans must be reported regularly to the bank's board of directors, and this amount must not exceed 100 percent of a bank's total capital, with a 30 percent limit for non-residential lending. The loan-to-value limits can also be waived for certain loans that are guaranteed or insured by the U.S. Government, its agencies, or state or local governments. Other exceptions include certain loan renewals and restructurings and loans in which an interest in real property is taken as collateral through "an abundance of caution."

Two other aspects of real estate lending — the use of property appraisals and the pricing of adjustable-rate loans — have become subject to federal regulation. Real estate appraisal standards, as

Table 3
Supervisory Loan-to-Value Limits*

<u>Real Estate Loan Category</u>	<u>Loan-to-Value Limit</u>
Raw Land	65 percent
Land Development	75 percent
Construction:	
Commercial Multifamily ** and other Nonresidential	80 percent
1-to-4 Family Residential	85 percent
Improved Property	85 percent
Owner-occupied 1-to-4 Family and Home Equity	***

* Institutions should establish their own internal loan-to-value limits for real estate loans. These limits should not exceed the limits in this table.

** Multifamily construction includes condominiums and cooperatives.

*** A loan-to-value limit has not been established for permanent mortgage or home equity loans on owner-occupied, 1-to-4 family residential property. However, for any such loan with a loan-to-value ratio that equals or exceeds 90 percent at origination, an institution should require appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral.

mandated by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, seek to ensure that bank real estate lending decisions are supported by independent evaluations of the property to be held as security. This act and the implementing regulations consequently require all banks to obtain a written appraisal from a state certified or licensed appraiser in connection with certain real estate loans and other financial transactions involving real property.

Several types of transactions are exempt from the appraisal requirements, most notably those that are unlikely to threaten the soundness of a bank and those that rely primarily on other sources

of repayment.³ Such exemptions include real estate loans and transactions with a value of \$250,000 or less, liens taken as collateral in an abundance of caution, and transactions involving real property where a bank either takes no security interest or takes an interest for purposes other than the property's value. Another exempt transaction is business loans of \$1 million or less in which the primary source of repayment is not derived from renting or selling real estate. Also exempt are real estate loans and mortgage-backed securities that are adequately supported by previous appraisals or by U.S. Government agency guarantees or underwriting requirements.

Standards for pricing adjustable-rate loans at national banks have been in place since 1981, when the Comptroller of the Currency first authorized national banks to offer such loans. Although the initial regulations required national banks to tie their rate adjustments to a selected group of indexes, the Comptroller now allows national banks to use any index beyond their own control that a borrower can readily verify. The Comptroller has also eliminated earlier restrictions on the size and frequency of interest rate adjustments and eased amortization requirements. In addition to these pricing parameters, Congress passed legislation in 1987 requiring mortgage lenders to specify a maximum interest rate or cap that could be charged on each adjustable-rate loan.

Apart from these federal regulations, many states impose their own real estate lending restrictions on state banks. Some states have requirements for loan-to-value ratios and for adjustable-rate mortgages. A number of states have usury ceilings on mortgage loans granted within the state.⁴ In addition, state banks, under the Garn-St Germain Act of 1982, may make or purchase any alter-

³ For these transactions, a less formal evaluation of the real estate can be used to provide an estimate of its value.

⁴ The Depository Institutions Deregulation and Monetary Control Act of 1980 preempted all state usury ceilings on residential mortgage loans, but states were given a three-year period during which they could reintroduce usury ceilings.

native mortgages that would be permissible for national banks, provided a state has not passed laws to prohibit such lending.

Margin requirements on securities loans — Another statutory lending restriction is margin requirements on securities loans. Margin requirements are set by the Board of Governors of the Federal Reserve System and grew out of the 1929 stock market collapse and the alleged role of banks and other lenders in financing the stock speculation of the 1920s. By setting margin requirements, the Board limits the credit banks and other lenders can extend when securities are held as collateral for a loan. This limit, however, only applies if the loan is to purchase or carry margin stocks and if these or other margin stocks are the securities held as collateral. Margin stocks are defined as stocks registered on the national exchanges, OTC stocks that qualify for trading in the National Market System (NMS securities), most mutual funds, debt securities convertible into a margin stock, and warrants or rights to purchase margin stocks.

The loan limit is expressed as a percentage of the market value of the collateral at the time the credit was extended. The percentage difference between the market value of the collateral (100 percent) and this maximum loan value is termed the margin requirement. For example, a margin requirement of 60 percent would mean that an investor could borrow only 40 percent of the market value of the collateral at the time the loan was originated.

The Board's authority to set specific margin requirements and issue any necessary regulations arises from the Securities Exchange Act of 1934.⁵ Margin requirements on stock-secured credit extensions by securities brokers and dealers are implemented through Federal Reserve Regulation T. Similar credit extensions by banks and other lenders are governed by Regulation U, and Regulation X applies margin requirements to credit obtained outside of the

⁵ 15 U.S.C. §78.

United States. The current margin requirement of 50 percent has been in effect since January 3, 1974.

Certain aspects of margin requirements have been debated for a number of years, including their overall role in financial markets and the desirability of eliminating differences in margin requirements across securities, options, and futures markets. In particular, a 1984 Federal Reserve staff study cast some doubt over the need to maintain high margin requirements to achieve a balanced distribution of credit, prevent stock speculation and excessive price fluctuations, and protect investors or brokers against assuming inappropriate risks.⁶ This study found that margin credit supported only a small portion of all stock holdings and that markets handling many of the new financial instruments operated reasonably well with less extensive regulation of margin credit. The Federal Reserve study and other studies of margin requirements provide some support for a more evenhanded approach across various financial instruments and for the restriction of high margin requirements to emergency situations. As other markets with lower margin restrictions continue to develop and expand, the role and use of securities margin requirements will likely receive further attention.

Selective credit controls — In addition to margin and real estate loan restrictions, banks have sometimes been subject to selective credit controls administered by the Federal Reserve. Consumer and real estate credit controls have typically been adopted during wartime as a means of channeling credit and materials toward war-related production. Credit controls have been imposed at other times to control inflationary pressures. In several cases, credit controls were imposed on more than just bank lenders. Examples of periods when credit controls were used are during World War II, the Korean War, and the spring and summer of 1980.

The benefits of credit controls, however, have been questioned

⁶ Staff of the Board of Governors of the Federal Reserve System, "Review and Evaluation of Federal Margin Requirements," Board of Governors, Washington, D.C., December 1984.

by many, and these controls have been difficult to implement in an effective and impartial manner. As a result, little support exists for using such constraints in situations other than the most urgent.

Examination and supervisory influence on credit quality — The major supervisory influence on the types, maturity, and quality of bank loans is through examination and supervision rather than through lending statutes. In a bank examination, bank loan portfolios are evaluated primarily with regard to their overall quality and their risk under different economic conditions. Since the majority of bank assets are typically loans, assessments of loan quality are central to an examination and to a determination of the protection provided bank depositors and the deposit insurance fund.

The first step in a supervisory loan evaluation is an analysis of a bank's formal loan policies and its adherence to these policies. A formal policy helps establish a bank's lending objectives, and without such policy guidance, lending officers would be more likely to make inappropriate or excessively risky loans. Bank lending policies may set general guidelines for bank liquidity, total loan volume relative to bank assets and capital, and the allocation of funds to different types of borrowers. Guidelines may also be included for credit approval criteria, collateral, documentation, repayment terms, and each officer's loan limits and responsibilities.

Supervisory authorities look next at the quality of individual loans, giving their greatest attention to the larger lines of credit. Loan quality is judged by the repayment ability of the bank's credit customers. This credit analysis includes a review of such significant factors as a borrower's net worth, cash flow, pledged collateral, payment history, and earnings prospects. Credits determined to have excessive risks and questionable collection characteristics are then classified by examiners into one of three categories and called to the attention of bank management and directors:

Substandard credits involve more than normal risk due to performance, financial condition, insufficient collat-

eral, or other factors, and deserve more than normal servicing and supervision.

Doubtful credits include those that have a probable loss, the amount of which cannot be readily determined.

Loss credits are regarded as uncollectible.

In addition, examiners may list an asset as *special mention* when it has potential weaknesses that deserve management's close attention. Such weaknesses could further affect repayment if left uncorrected.

The three classification categories are important in determining the condition of the loan portfolio, because they reflect not only the volume but also the severity of criticized loans. In the bank rating system used by the three federal regulators, the total amount of classifications in each category is considered in assessing the quality of a bank's loans and assets and the adequacy of its capital and loan loss reserves. The Federal Reserve, for example, calculates a weighted classification figure by taking 20 percent of substandard, 50 percent of doubtful, and all of the loss classifications. This number is then compared to a bank's capital, and the resulting ratio serves as a measure of asset risk exposure in a bank.

Although banks cannot avoid some unforeseen loan problems and losses, bankers are expected to limit such losses by controlling the amount of risk they assume. Thus, in analyzing credit risks, examiners also look at whether bankers have avoided such credits as speculative loans, loans to borrowers of undesirable character, working capital loans to highly leveraged businesses, and unsecured loans that cannot be supported by a borrower's cash flow and tangible net worth. Bankers should further avoid loans to businesses where the bank's lending effectively represents an equity investment that should more appropriately be provided by

investors. In addition, bank supervisors look at the maturity structure of a bank's loan portfolio and note any concentration of long-term, fixed-rate loans. Such loans could leave banks vulnerable to changes in interest rates and inflation, much as occurred with the thrift industry in the late 1970s and early 1980s.

Bank supervisors also evaluate bankers on how well they have avoided loan concentrations, such as to an individual and related interests or to a single industry, product line, or type of collateral. Risk diversification is a fundamental tenet of banking and finance, serving to insulate banks from downturns in any one specific area. Adequate diversification may not always be possible, however, because some banks serve a very narrow base of loan customers. A bank may be located in a town dominated by a single employer, for example, or in an area dependent on a single industry, such as agriculture. In these instances, supervisors might expect bank managers to maintain higher credit and collateral standards to offset any loan concentration risks. Of more concern to supervisors is a failure by bank management to take advantage of opportunities to diversify when such opportunities exist.

The effect of supervisory credit evaluation on bank lending activities is difficult to judge overall. Ideally, these credit reviews represent a cooperative sharing of information among bankers and examiners, and an important role of examinations should be to provide a bank's management, board of directors, and its supervisory authorities with an independent evaluation of the bank's lending function. While most bankers would naturally avoid the types of loans and loan policies that examiners judge too risky, examinations may help to encourage some bankers to adopt sounder lending policies. Periodic loan examinations may also give bankers an added incentive to take timely action on problem credits. Finally, supervisory loan reviews help enforce the statutes and regulations on credit extensions, ensure that loan documentation is sufficient for an adequate credit analysis, and give supervisors a

detailed picture of a bank's condition and possible need for supervisory action.

Limits on loans to a single borrower — Bank lending decisions are affected not only by supervisory reviews and statutes relating to specific types of loans, but also by several general credit regulations. Federal and state laws, for example, limit the size of loans that can be made to a single borrower. The intent of these laws is to spread the risks that a bank assumes and not leave the bank vulnerable to difficulties encountered by a few major borrowers.

At national banks, this statutory lending limit is 15 percent of the bank's unimpaired capital and surplus for loans that are not fully secured. Another 10 percent of unimpaired capital and surplus may be lent if this additional amount is fully secured by readily marketable collateral. In its regulations on lending limits, the OCC has defined capital and surplus to be a bank's Tier 1 and Tier 2 capital under the risk-based capital requirements, plus the balance of the allowance for loan and lease losses not included in Tier 2 capital.⁷

State bank lending limits cannot be summarized easily. There is considerable variation across states in the limits for unsecured loans, as there is in the exceptions made for collateralized credits and the definition of single borrowers. Many state laws and regulations are aimed at achieving parity with the national bank provisions, but a significant number of states have authorized higher lending limits for state banks. Compliance with legal lending limits for both state and national banks is reviewed during examinations of banks and their loan portfolios.

These lending limits for national banks and state banks generally apply to any direct and indirect obligations of a borrower, including any partnership interests. For corporations, the obligations of a parent company are most often combined with those of

⁷ *Revised Statutes*, sec. 5200; 12 U.S.C. §84, and 12 CFR 32. A few exceptions to these lending limits exist for loans secured by special types of collateral. For information on the components of Tier 1 and Tier 2 capital, see pages 86–88 of this book.

any majority-owned or majority-controlled subsidiaries to determine compliance with legal lending limits. Violations of this statute can often be attributed to a bank's failure to aggregate all the credits extended directly to a borrower together with his or her liability as endorser or guarantor on related interests.

Bank supervisors consider excessive lending to a single borrower a serious matter requiring immediate correction. Such lending provides inadequate diversification and could result in substantial losses in bank capital if a few large borrowers were to default on their obligations. In fact, a notable number of bank and savings and loan association failures over the last few decades have been traced to fraudulent borrowers using a variety of related interests and corporate ruses to obtain excessive credit extensions. While several of these failures were the result of insider dealings, many large loan losses have involved honest bankers who failed to keep track of each borrower's related interests and total indebtedness.

Loans to insiders — Another credit restriction applies to insider loans. The basic reason for insider lending restrictions is to prevent those in charge of a bank from using their positions to obtain credit on preferential terms and outside normal credit underwriting standards. Such restrictions help ensure that a bank's lending is in the best interest of its depositors and community.

Loans by member banks of the Federal Reserve System to their executive officers became subject to close supervision after the banking crisis of the 1930s. In 1978, additional insider lending restrictions were extended to the executive officers, directors, and principal shareholders of all insured banks. Also, borrowings by any of these parties from correspondent banks became subject to a number of standards. Several of the insider lending restrictions were further tightened by the Federal Deposit Insurance Corporation Improvement Act of 1991.

Insider loan restrictions on member banks and their subsidiaries are covered in sections 22(g) and 22(h) of the Federal Reserve Act

and implemented through Regulation O.⁸ Under Regulation O, extensions of credit by a member bank to any of its executive officers, directors, or principal shareholders, or to any of their related interests, must be on substantially the same terms, including interest rates and collateral, as comparable transactions with outside parties.⁹ These transactions must involve no more than normal credit risk and must also follow credit underwriting procedures that are no less stringent than for other borrowers. Other bank employees and shareholders are not subject to Regulation O.

Any extension of credit to an executive officer, director, or principal shareholder that exceeds a specified amount requires the prior approval of a majority of the entire board of directors of the bank. The banking agencies presently require board approval when an insider loan exceeds the higher of \$25,000 or 5 percent of the bank's unimpaired capital and surplus. For purposes of this limit, a loan must be aggregated with other credit extensions to the same individual and all related interests of that person. A loan to an insider would also require board approval if that loan, when aggregated with all loans to that person, exceeds \$500,000. The interested party must abstain from any participation, direct or indirect, in the board's deliberation.

Extensions of credit by a member bank to any of its executive officers, directors, or principal shareholders and their related interests must also comply with the same single borrower limit imposed on national banks — 15 percent of the bank's unimpaired capital and surplus for loans not fully secured and an additional 10 percent of unimpaired capital and surplus for loans fully secured by readily

⁸ 12 U.S.C. §375a, 12 U.S.C. §375b, and 12 CFR 215.

⁹ Regulation O and the insider lending statutes define an executive officer as "a person who participates or has authority to participate in major policymaking functions of the company or bank." A principal shareholder is anyone "that directly or indirectly, or acting through or in concert with one or more persons, owns, controls, or has the power to vote more than 10 percent of any class of voting securities of a member bank or company."

marketable collateral. In addition, a bank's total lending to all insiders generally may not exceed its unimpaired capital and surplus.¹⁰

Other Regulation O provisions limit overdrafts by executive officers and directors and impose additional restrictions on borrowing by executive officers. A member bank generally may not pay overdrafts of an executive officer or director, except in accordance with a written, preauthorized, interest-bearing extension of credit or a written, preauthorized transfer of funds from another account. In lending to their executive officers, member banks may extend credit for an officer's residence or children's education. Any other loans to an executive officer must not exceed an amount prescribed by the appropriate federal banking agency.¹¹

Section 18(j)(2) of the Federal Deposit Insurance Act extends insider lending restrictions to nonmember insured banks. Under this section, the provisions summarized above apply "in the same manner and to the same extent as if the nonmember insured bank were a member bank."

Insider lending restrictions are enforced through reporting requirements and bank examinations. Banks must maintain a record of credit extensions to their executive officers, directors, and principal shareholders. A bank must also report quarterly, in conjunction with the Report of Condition, the total amount of credit extended to its executive officers, directors, principal shareholders, and their related interests.¹² A bank is further required to report the number

¹⁰ To help attract directors and avoid restricting credit in small communities, banks with total deposits of less than \$100 million may establish an aggregate insider lending limit of up to twice unimpaired capital and surplus. Any bank adopting such a limit must maintain adequate capital and satisfactory supervisory ratings, and its board of directors must adopt a resolution certifying the necessity of a higher limit.

¹¹ Presently, such lending to any executive officer must not exceed the higher of \$25,000 or 2.5 percent of the bank's capital and unimpaired surplus up to a limit of \$100,000. These limits do not apply to loans that are fully secured by U.S. Government obligations or by a deposit account at the lending bank.

¹² When filing their Reports of Condition, banks must also specify the number of loans made to executive officers since the previous reporting date, the total dollar amount of these loans, and the range of interest rates charged on the loans. This information, however, is not treated as part of the actual Report of Condition.

of such insiders having loans which exceed the lesser of 5 percent of the bank's unimpaired capital and surplus or \$500,000. The names of any executive officers and principal shareholders in this group are to be disclosed to the public upon written request, provided the loans to a particular individual and related interests exceed \$25,000. Insider lending records and compliance with the regulations are further verified during the regular examination of a bank.

In addition to the federal regulations, state banks, both member and nonmember, must comply with state statutes on lending to insiders. Several states have laws that closely mirror the federal statutes. In other states, however, the statutes may vary with regard to what size of loan must be approved by a bank's board of directors, the specific lending limits in relation to bank capital or in actual dollar amounts, the type of insiders included — executive officers, directors, or principal shareholders, and the extent to which any related interests of an insider are included in the restrictions.

Apart from the regulations on insiders borrowing from their own banks, federal restrictions also extend to borrowing from correspondent banks.¹³ Under these restrictions, preferential lending by a bank to the executive officers, directors, or principal shareholders of another bank is prohibited when there is a correspondent relationship between the banks. Nor can a correspondent account be opened if preferential lending already exists between one of the banks and an executive officer, director, or principal shareholder of the other bank. Public disclosure requirements on loans from correspondent banks are similar to those on insider loans.

Insider lending restrictions have helped to curb insider abuses and limit other violations to inadvertent mistakes, such as a failure to aggregate all loans to an individual. Bankers and regulators, however, must continue to take a careful look at ownership and management lending practices. Insider abuses have been a com-

¹³ These restrictions on borrowing from correspondent banks are contained in 12 U.S.C. §1972(2).

mon factor in many troubled institutions and are still a significant concern in banking. Studies of failing banks, for instance, have often cited such insider problems as fraud and losses on insider loans as a key factor in the failures. A 1994 U.S. General Accounting Office report noted that insider problems had been found in 65 percent of the bank failures over a two-year period, with these problems representing one of the major reasons for failure in 26 percent of the banks.¹⁴

Acceptable types and maturity distribution of securities — To limit portfolio risks on investments and provide liquidity, banks are authorized to purchase and hold only certain types of debt securities. Other aspects of a bank's securities holdings are also of regulatory interest, including the valuation and classification of securities, maturity structure and overall liquidity of the portfolio, and restrictions on holding equity securities.

A member bank cannot hold investment securities of any one obligor totaling more than 10 percent of its unimpaired capital and surplus.¹⁵ Investment securities are defined as marketable obligations evidencing indebtedness of any person, copartnership, association, or corporation in the form of bonds, notes and/or debentures. The Comptroller of the Currency has also defined investment securities to exclude securities that are predominantly speculative. Under these definitions, member banks are allowed to purchase securities in only the four highest rating grades estab-

¹⁴ U.S. General Accounting Office, *Bank Insider Activities: Insider Problems and Violations Indicate Broader Management Deficiencies*, GAO/GGD-94-88, March 30, 1994.

Other studies that have examined insider abuses at failing banks include: George W. Hill, *Why 67 Insured Banks Failed – 1960-1974*, Washington, D.C., Federal Deposit Insurance Corporation, 1975; Joseph F. Sinkey, Jr., "Problem and Failed Banks, Bank Examinations, and Early Warning Systems: A Summary," in E. I. Altman and A. W. Sametz, eds., *Financial Crises* (New York: Wiley-Interscience, 1977), pp. 24-47; and Office of the Comptroller of the Currency, *Bank Failure: An Evaluation of the Factors Contributing to the Failure of National Banks*, June 1988.

¹⁵ The investment securities and corporate stock holdings of national banks are restricted by the *Revised Statutes*, sec. 5136 (12 U.S.C. §24, as implemented by 12 CFR 1). The same statutes are extended to state member banks by 12 U.S.C. §335.

lished by the rating agencies (AAA, AA, A, and BAA) or unrated securities of equivalent quality. The limits on holding securities of any one obligor do not apply to obligations issued or guaranteed by the U.S. Treasury or general obligations of states and political subdivisions. In addition, the Gramm-Leach-Bliley Act of 1999 removes the single obligor limitation for municipal revenue bonds purchased by well-capitalized member banks. Most states also have comparable restrictions on the types of debt securities state banks can hold, although a number of states allow some noninvestment securities to be held.

Accounting standards influence the way in which investment securities at both state and national banks are evaluated for reporting purposes. In 1994, banks were required to adopt certain provisions of the Financial Accounting Standards Board Statement No. 115, which requires securities to be divided into three categories: held-to-maturity, available-for-sale, and trading securities.

Under these standards, only the debt securities that a bank has the positive intent and ability to hold to maturity may be included in its held-to-maturity account. These securities are to be evaluated at their amortized cost for reporting purposes and capital calculations. Trading securities, which are the securities that a bank buys and holds principally for the purpose of selling in the near term, are to be reported at fair value (i.e., market value). In addition, any unrealized appreciation or depreciation in the value of these securities is to be reported on a bank's income statement and directly reflected in its earnings.

Securities in the available-for-sale category are those that a bank does not intend to trade actively, but also does not plan or have the ability to hold to maturity. While such securities are to be reported at fair value, any appreciation or depreciation in their value will not be reflected in a bank's reported earnings. Also, the banking agencies have agreed not to incorporate these unrealized gains or losses in risk-based capital calculations, but they will pay close attention to the amount of any unrealized losses.

Apart from these accounting provisions, several special examination rules apply to the classification and valuation of noninvestment grade securities at insured banks.¹⁶ For securities that deteriorate to below investment grade, any depreciation in their market value relative to book value is to be classified by examiners as doubtful, and any remaining book value will be classified as substandard. The depreciation in defaulted securities is generally classified as loss. An exception to these rules, however, may be made for subinvestment-quality municipal general obligations backed by the credit and taxing power of the issuer. The entire amount of any such obligation may be classified substandard as long as it is not in default.

These classifications thus provide an indication of the soundness of a bank's securities portfolio. Moreover, in computing the net sound capital of a bank, bank regulators deduct from a bank's reported capital 50 percent of the doubtful classifications and all the loss classifications on securities and loans.

Examiners not only assess the soundness of a bank's securities portfolio, but also review the portfolio's maturity structure. This analysis focuses on whether maturities have been managed in a manner that will ensure ready funds for meeting general business fluctuations and will help minimize a bank's overall exposure to interest rate changes. This regulatory attention further reflects the fact that a bank's securities portfolio is expected to fulfill a variety of purposes, including acting as a source of liquidity and income and being part of a bank's interest rate risk management strategy.

Bank authority to hold equity securities has been much more restrictive than for debt securities. For instance, in response to the investment banking problems of the 1920s and early 1930s, federal banking laws were amended to specifically prohibit member banks from purchasing and holding corporate stocks for their own

¹⁶ "Revision in Bank Examination Procedures," *Federal Reserve Bulletin* 65 (May 1979), pp. 406-408.

accounts. Also, while several states have given their banks limited equity investment powers in recent years, the Federal Deposit Insurance Corporation Improvement Act of 1991 now restricts state banks to the same holdings as national banks except for limited grandfather rights.

As a result of these steps, the stock holdings of banks are generally limited to such things as Federal Reserve bank stock, stock of subsidiary service corporations or bankers banks, qualified housing projects, and stock acquired temporarily as collateral on defaulted loans. The Gramm-Leach-Bliley Act of 1999 further allows national and state banks to invest in financial subsidiaries, which are authorized to conduct a broader range of financial activities than are permissible for banks. To do so, though, a bank and any depository institutions affiliated with it must be well capitalized and well managed and have satisfactory or better CRA ratings.

Maintenance of adequate capital

A commercial bank must have enough capital to provide a cushion for absorbing possible loan losses or other problems, funds for its internal needs and expansion, and added security for depositors and the deposit insurance system. In addition, higher capital serves to increase the financial stake that stockholders have in the safe and sound operation of a bank. Consequently, bank regulators view capital as a key element in holding banking risks to an acceptable level.

Capital adequacy determinations, though, have posed problems for bankers and regulators, since capital needs can depend on a wide variety of factors. Some of these factors are a bank's risk profile and the activities it undertakes, its size and access to capital markets, and future and often unforeseen economic and financial conditions. In addition, not all components of capital offer the same benefits and protection to a bank. For example, subordinated debt protects bank depositors, but it differs from equity capital

instruments in that it has a limited life and also places a fixed demand on bank revenues. Another complicating factor is that banks and their customers receive protection from deposit insurance and other elements of the federal safety net, thus potentially weakening and leaving less of a role for the usual market forces in determining bank capital needs. To deal with these complexities, bank supervisors typically assess a bank's capital in relation to both industry-wide standards and individual banking factors. They also look at a number of different capital components.

Maintaining adequate capital and accurately assessing capital needs have assumed further prominence in the supervision of banks over the past few years. The Federal Deposit Insurance Corporation Improvement Act of 1991 created a new supervisory framework linking enforcement actions closely to the level of capital held by a bank. This system of supervision, commonly known as prompt corrective action, represents an attempt to provide a timely and nondiscretionary triggering mechanism for supervisory actions. Key objectives of such actions are to resolve banking problems at an early stage and at the least possible cost to the bank insurance fund. Under prompt corrective action, for instance, federal banking agencies must institute progressively more severe supervisory responses as a bank's capital declines. As a result, these prompt corrective action standards have become the primary regulatory influence over bank capital levels.

Another recent factor influencing supervisory policies on capital is the substantial progress that banks are achieving in measuring and controlling their risk exposures. Many banks are using internal credit rating systems, financial models, and other means to allocate capital better and to assess their overall capital needs. In addition, financial innovation is leading to better means for controlling risk exposures — most notably through more sophisticated hedging practices, securitized assets, swaps, credit derivatives, and other forms of derivatives. This progress in measuring and controlling risk is beginning to influence how supervisors assess

bank capital adequacy and will undoubtedly play a key role in future capital standards.

Capital measures — Under the 1991 legislation, the federal banking agencies must assign each bank to one of five possible capital categories: (1) well-capitalized; (2) adequately capitalized; (3) undercapitalized; (4) significantly undercapitalized; and (5) critically undercapitalized.¹⁷ These categories provide the basic framework for prompt corrective action and determine whether a bank will be subject to enforcement actions. Banks that are in the top two capital categories will not be subject to any prompt corrective action enforcement steps. On the other hand, banks that fall below these categories will face a set of mandatory enforcement actions that may also be supplemented by other actions at the supervisor's discretion.

To assign banks to the capital categories, regulators look at three basic capital ratios: total capital to risk-weighted assets (Total risk-based capital ratio), Tier 1 capital to risk-weighted assets (Tier 1 risk-based capital ratio), and Tier 1 capital to total average assets (Leverage ratio).¹⁸ These three standards attempt to capture different aspects and components of a bank's capital holdings, while relating such holdings more directly to the bank's risk profile. The level of capital a bank holds under each of these ratios will determine the particular capital category assigned to this bank. In addition, the agencies follow a tangible equity capital-to-total average assets ratio (Tier 1 capital plus cumulative perpetual preferred stock in relation to total average assets) for determining whether a bank is in the critically undercapitalized category.

In constructing these capital ratios, bank supervisors must first divide a bank's capital into two basic components: Tier 1 or core

¹⁷ The prompt corrective action provisions are contained in section 131 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (12 U.S.C. §1831o).

¹⁸ These capital ratios and their individual components primarily reflect a 1988 agreement on a common risk-based capital framework that the federal banking agencies reached with the bank regulatory authorities of 11 other major countries through the Basel Committee on Banking Supervision. This international agreement has subsequently been adopted by over 100 countries.

capital and Tier 2 or supplementary capital. Tier 1 capital represents the most permanent form of capital and the highest quality of capital that is available to absorb losses. The elements in Tier 2 capital, while still providing protection against losses, may be of a limited life and carry an interest obligation or other characteristics of debt instruments.

The components of Tier 1 or core capital consist of:

- common stockholders' equity
- noncumulative perpetual preferred stock
- minority interests in the equity accounts of consolidated subsidiaries

Goodwill and certain other intangible assets are deducted from Tier 1 capital.¹⁹ Based on these components and exclusions, Tier 1 capital thus represents the most stable and readily available form of capital for supporting a bank's operations.

Tier 2 or supplementary capital includes:

- the allowance for loan and lease losses (up to a maximum of 1.25 percent of risk-weighted assets)
- cumulative perpetual or long-term preferred stock
- hybrid capital instruments and mandatory convertible debt securities
- subordinated debt and intermediate-term preferred stock
- unrealized holding gains on equity securities

The amount of subordinated debt and intermediate-term preferred stock that a bank counts as supplemental capital cannot be more than 50 percent of its Tier 1 capital. In addition, these two

¹⁹ Any items that are deducted from capital are also deducted from risk-weighted assets in computing risk-based capital ratios. Intangible assets that reflect purchased mortgage servicing rights and purchased credit card relationships, however, may be included in Tier 1 capital provided they meet certain criteria regarding their value.

components and any other limited-life capital instruments are discounted in Tier 2 computations as they approach maturity. This discount factor is one-fifth of the original amount of the instrument for each additional year during the instrument's last five years of maturity (20 percent discount for remaining maturities of four to five years, 40 percent discount for three to four years to maturity, ..., and 100 percent discount for less than a year to maturity).

For the prompt corrective action standards, a bank's Tier 1 and Tier 2 capital are added together to make up the total capital component in the total risk-based capital ratio.²⁰ Tier 1 or core capital is used separately in constructing the Tier 1 risk-based capital ratio and the leverage ratio. The tangible equity ratio is calculated using Tier 1 capital plus the amount of outstanding cumulative perpetual preferred stock.²¹ Both the leverage and tangible equity ratios use total bank assets as their base, which is defined as the quarterly average of total assets reported in a bank's Report of Condition.

For the total and Tier 1 risk-based capital ratios, the capital components are compared to a risk-weighted assets base, thereby providing a closer link between a bank's capital needs and its risk profile. In computing this asset base, the capital standards assign bank assets and off balance sheet items to one of four general categories of credit risk, as determined by such risk factors as the type of obligor on each asset and the existence of any collateral or guarantees. Each category receives its own risk weight — either 0, 20, 50, or 100 percent — and the greater weights are applied to those items generally thought to pose more risk to a bank. The dollar amount of items a bank has in each risk category is then multiplied by the appropriate risk weight, and the resulting figures are added across the categories to derive the bank's overall risk-weighted

²⁰ If a bank has investments in unconsolidated banking and finance subsidiaries or has reciprocal holdings of capital instruments of another bank, these items must be deducted from this total capital measure.

²¹ Like Tier 1 capital, the tangible equity measure includes the value of certain purchased mortgage servicing rights, while excluding goodwill and most other intangible assets.

Table 4
Summary of Risk Weights and
Major Assets in Each Risk Category

Category 1 – Zero Percent Weight

Cash

Balances due from Federal Reserve Banks and claims on central banks in other OECD countries¹

U.S. Treasury and Government agency securities and claims on or unconditionally guaranteed by OECD central governments

Federal Reserve stock

Claims collateralized by cash on deposit or by securities issued or guaranteed by OECD central governments or U.S. Government agencies

Category 2 – 20 Percent Weight

Cash items in the process of collection

All claims on or guaranteed by U.S. depository institutions and banks in OECD countries

General obligation bonds of state and local governments

Portions of claims secured by U.S. Government agency securities or OECD central government obligations that do not qualify for a zero percent weight

Loans or other claims conditionally guaranteed by the U.S. Government Securities and other claims on U.S. Government-sponsored agencies

Category 3 – 50 Percent Weight

Loans secured by first liens on 1-to-4 family residential property and certain multifamily residential properties

Certain privately issued mortgage-backed securities

Revenue bonds of state and local governments

Category 4 – 100 Percent Weight

All loans and other claims on private obligors not placed in a lower risk category

Bank premises, fixed assets, and other real estate owned

Industrial development revenue bonds

Intangible assets and investment in unconsolidated subsidiaries, provided they are not deducted from capital

¹ The group of countries associated with the Organization for Economic Cooperation and Development (OECD) includes the United States and 24 other major industrial countries.

assets measure. As a result, higher risk assets will make a more prominent contribution to this risk-weighted base and thus will require greater capital backing.

Table 4 shows the risk weights and major items in each of the four risk categories. Items with little or no credit risk, such as cash and claims on central banks or governments, are in the first category with a zero percent risk weight. On the other hand, most claims against private parties appear in categories 3 and 4 with 50 and 100 percent risk weights, respectively.

Before off balance sheet items receive a risk weighting, they are first converted into balance sheet credit equivalents. The conversion factors used in this process depend on the extent to which an off balance sheet item substitutes for or is likely to result in a bank asset. Items that serve as direct credit substitutes, for example, are converted on a one-to-one basis, while the dollar amount of items posing less risk to a bank may be multiplied by conversion factors of 0, 20, or 50 percent.²²

Capital standards and enforcement steps under prompt corrective action — Under the prompt corrective action standards, bank regulators assign individual banks to one of five capital categories. As shown in Table 5, a bank's capital holdings under the three basic capital measures will determine its capital category. A well-capitalized or adequately capitalized bank must meet or exceed the min-

²² The conversion factors and related items are: 100 percent (direct credit substitutes, such as financial standby letters of credit; sale and repurchase agreements; asset sales with recourse; forward agreements to purchase assets; and securities lent that place a bank at risk), 50 percent (transaction-related contingencies, such as performance bonds and performance-based standby letters of credit; unused portions of commitments with an original maturity over one year; and revolving underwriting facilities), 20 percent (short-term, self-liquidating, trade-related contingencies, such as commercial letters of credit), and 0 percent (unused portions of commitments that either have an original maturity of under one year or are unconditionally cancelable).

In addition, conversion factors of 0, 0.5, and 1.5 percent apply to interest rate contracts, while factors of 1, 5, and 7.5 percent apply to exchange rate contracts. The higher percentages apply to contracts with a remaining maturity over one year. The notional amount of a contract is multiplied by the appropriate conversion factor to yield a measure of potential credit exposure, and this measure is added to the replacement cost or current credit exposure of the contract.

Table 5
Prompt Corrective Action Capital Guidelines

<u>Capital categories</u>	<u>Total risk-based capital ratio</u>		<u>Tier 1 risk-based capital ratio</u>		<u>Leverage ratio</u>
Well capitalized*	10 percent or greater	AND	6 percent or greater	AND	5 percent or greater
Adequately capitalized	8 percent or greater	AND	4 percent or greater	AND	4 percent or greater**
Undercapitalized	Less than 8 percent	OR	Less than 4 percent	OR	Less than 4 percent**
Significantly undercapitalized	Less than 6 percent	OR	Less than 3 percent	OR	Less than 3 percent
Critically undercapitalized***	—		—		—

* In addition to meeting these capital standards, a well-capitalized bank must not be subject to any written agreement, order, capital directive, or prompt corrective action directive that requires the bank to meet and maintain a specific capital level for any capital measure.

** An adequately capitalized bank may have a leverage ratio of 3 percent or greater if its most recent examination rating was a "1" and it is not experiencing or anticipating significant growth. For an undercapitalized bank, the leverage ratio criteria is "less than 3 percent" if the bank's most recent examination rating was a "1" and the bank is not experiencing or anticipating significant growth.

*** A bank is critically undercapitalized if its ratio of tangible equity to total assets is equal to or less than 2 percent.

imum percentages listed in the table for all three capital ratios. To be deemed undercapitalized or significantly undercapitalized, a bank need only fall below one of the percentages listed for its capital category.²³ Critically undercapitalized banks are those with tangible equity equal to or less than 2 percent of their total assets.

These capital categories provide the basis for taking supervisory action and issuing directives under the prompt corrective action framework. This framework establishes a set of mandatory actions that regulators must take whenever a bank fails to maintain adequate capital. As shown in Table 6, these mandatory supervisory actions become more severe as a bank's capital declines. Well and adequately capitalized banks will not be subject to the mandatory actions as long as they do not take any steps that would leave them undercapitalized. For undercapitalized and significantly undercapitalized institutions, much of the focus is on submitting and implementing an acceptable plan to restore capital. Critically undercapitalized banks face receivership unless their condition improves quickly, and activities that might increase their risk exposure are to be restricted.

In addition to the mandatory actions, the prompt corrective action framework also includes a list of discretionary steps. For undercapitalized banks, the supervisory agencies may choose to take such steps if appropriate. With significantly undercapitalized banks, though, the agencies must impose at least one of the discretionary actions as a supplement to the mandatory provisions. Table 7 provides a listing of the suggested discretionary actions.

The prompt corrective action statutes provide federal banking agencies with the authority to take the specified steps against institutions within a given capital category. Supervisory agencies also

²³ A federal banking agency may elect to reclassify a well-capitalized bank as adequately capitalized or to require an adequately capitalized or undercapitalized bank to comply with more severe supervisory actions. Such changes may be made when a bank is in an unsafe or unsound condition or has failed to correct a less-than-satisfactory examination rating for asset quality, management, earnings, liquidity, or sensitivity to market risk.

Table 6
Mandatory Supervisory Actions Applicable to
Institutions in the Various Capital Categories

**Well Capitalized and
Adequately Capitalized**

May not make any capital distribution or pay a management fee to a controlling person that would leave the institution undercapitalized.

Undercapitalized

Subject to provisions applicable to well capitalized and adequately capitalized institutions.

Subject to increased monitoring.

Must submit an acceptable capital restoration plan within 45 days and implement that plan.

Growth of total assets must be restricted.

Prior approval from the appropriate agency is required prior to acquisitions, branching, and new lines of business.

Significantly Undercapitalized

Subject to all provisions applicable to undercapitalized institutions.

Bonuses and raises to senior executive officers must be restricted.

Subject to at least one of the discretionary actions presented in Table 7.

Critically Undercapitalized

Must be placed in receivership or conservatorship within 90 days unless the appropriate agency and the FDIC concur that other action

**Critically Undercapitalized,
*continued***

would better achieve the purposes of prompt corrective action.

Must be placed in receivership if it continues to be critically undercapitalized, unless specific statutory requirements are met.

After 60 days, must be prohibited from paying principal or interest on subordinated debt without prior approval of the FDIC.

Activities must be restricted. At a minimum, may not do the following without the prior written approval of the FDIC:

Enter into any material transactions other than in the usual course of business;

Extend credit for any highly leveraged transaction;

Make any material change in accounting methods;

Engage in any "covered transactions" as defined in section 23A of the Federal Reserve Act, which governs affiliate transactions;

Pay excessive compensation or bonuses;

Pay interest on new or renewed liabilities at a rate that would cause the weighted average cost of funds to significantly exceed the prevailing rate in the institution's market area.

Table 7
**Discretionary Supervisory Actions Applicable to
 Institutions in the Various Capital Categories**

**Well Capitalized and
 Adequately Capitalized**

None.

Undercapitalized

Subject to any discretionary actions applicable to significantly undercapitalized institutions if the appropriate agency determines that those actions are necessary to carry out the purposes of prompt corrective action.

Significantly Undercapitalized
 (Or undercapitalized banks that fail to submit or implement an acceptable capital plan)

Actions the institution is presumed subject to unless the appropriate agency determines that such action would not further the purpose of prompt corrective action:

Must raise additional capital or arrange to be merged with another institution;

Transactions with affiliates must be restricted;

Interest rates paid on deposits must be restricted to prevailing rates in the region.

Other possible discretionary actions:

Severely restrict asset growth or reduce total assets;

Terminate, reduce, or alter activities that pose excessive risk to the institution;

Significantly Undercapitalized,
continued

Require the institution to elect a new board of directors, dismiss any director or senior executive officer, or employ qualified senior executive officers;

Prohibit acceptance of deposits from correspondent depository institutions;

Prohibit any controlling BHC from making any capital distribution without prior approval from the Federal Reserve Board;

Divest or liquidate any subsidiary in danger of becoming insolvent and posing a significant risk to the institution;

Require any controlling company to divest or liquidate any non-depository institution affiliate in danger of becoming insolvent and posing a significant risk to the institution;

Any other action that the appropriate agency determines would better carry out the purposes of Prompt Corrective Action.

Critically Undercapitalized

Additional restrictions (other than those mandated) may be placed on activities.

have authority under other statutes to take enforcement steps. In particular, provisions of the International Lending Supervision Act of 1983 give federal supervisory agencies general authority to issue capital directives to banks that fail to maintain appropriate capital levels. These directives may encompass the submission of an acceptable plan for restoring capital.

Proposed revisions to the risk-based capital framework – Since its adoption in the late 1980s, the risk-based capital framework has been highly successful in strengthening capital standards across many countries and in creating a common international standard for capital adequacy. More recently, though, these standards have shown a number of weaknesses. New, complex financial instruments, for instance, have made the standards more difficult to implement, and the existing risk weights have failed to address significant differences in the quality of individual loans and other assets. Also, the standards do not adequately adjust for steps an institution may take to mitigate its risk exposure, such as through the use of guarantees, collateral, netting agreements, or credit derivatives. These shortcomings have thus provided institutions with opportunities to arbitrage the standards and to assume higher risk profiles without adding more capital.

In response to these concerns, the Basel Committee on Banking Supervision issued a consultative paper in June of 1999 proposing a new capital adequacy framework. This framework would consist of three pillars: revised capital standards, a supervisory review process, and effective use of market discipline. The Committee suggested several alternatives for revising the capital standards. A principal element of the new standards is likely to be an internal ratings-based approach to credit risk, under which institutions with strong internal credit ratings systems would be allowed to use these systems to calculate the appropriate risk weights for their loans and corresponding capital needs. The Committee is also looking at whether external credit assessments, such as those developed by private rating agencies, or other standard

indicators of credit risk could be used to help assign risk weights. In addition, the consultative paper discusses methods for allowing greater recognition of credit risk mitigation instruments and techniques. The Committee has circulated these proposals for public comment and has plans to implement a new capital adequacy framework in 2001.

In addition to these proposals, the federal banking agencies have also discussed simplifying the capital standards for banks that do not have international operations and do not engage in complex activities, as might be determined by a bank's asset size, nature of its activities, and risk profile. This approach would allow regulators to establish more complicated capital standards for larger banks with refined risk-management systems, while easing compliance for smaller institutions. Ideas for a simplified approach include a risk-based capital standard with risk weights tailored more closely to the structure and activities of non-complex institutions, a leverage ratio, or a modified leverage ratio that accounts for off-balance sheet exposures.

Other aspects of capital adequacy — In section 305 of the Federal Deposit Insurance Corporation Improvement Act of 1991, Congress asked the federal banking agencies to revise their risk-based capital standards to take account of interest rate risk, concentration of credit risk, and the risks of nontraditional activities. The banking agencies amended their risk-based capital guidelines to stress that these risks, as well as the overall ability of bank management to control financial and operating risks, should be considered in any capital adequacy assessments.

In addition, the federal banking agencies expanded their risk-based capital standards in 1997 to specifically address market risk in bank trading activities, as well as in foreign exchange and commodity positions taken in other parts of a bank. The market risk capital guidelines are based on a framework developed jointly by supervisory authorities from the countries represented on the Basel Committee on Banking Supervision. These guidelines apply to

institutions with a significant exposure to market risk through their trading activities. Under the guidelines, institutions must adjust their risk-based capital ratios to take account of losses that could arise from broad market movements in interest rates, equity prices, foreign-exchange rates, or commodity prices. In addition, institutions must account for changes in market values due to more specific risks, such as the credit risk of the issuer of a particular financial instrument. Banks subject to the market risk standards must use their own internal models to measure market exposures, and these models and an institution's risk management practices must meet certain requirements under the implementing regulations.

The capital adequacy of bank holding companies is primarily evaluated by the Federal Reserve System. However, the FDIC and Comptroller of the Currency consider the condition of a holding company and its subsidiaries when they assess capital adequacy at individual banks under their jurisdiction. With several exceptions, bank holding company risk-based capital ratios are computed in much the same manner as for banks. Under Federal Reserve guidelines, bank holding companies with over \$150 million in consolidated assets are expected to maintain a total capital-to-risk-weighted assets ratio of at least 8.0 percent and a Tier 1 capital-to-risk-weighted assets ratio of 4.0 percent or more. Several special capital rules apply to financial holding companies and their subsidiaries. The Federal Reserve, for instance, may not impose capital adequacy standards on nondepository subsidiaries that are in compliance with the capital requirements of their federal regulator or state insurance authority.

Capital adequacy policies and decisions of state authorities differ in some ways from federal policies. However, many of the same factors are taken into account. National and state banks also face a number of other regulations relating to their capital holdings. Banks are prohibited from withdrawing or impairing their capital through excessive dividend payouts or other means. Member banks must have regulatory approval to pay dividends that exceed

net profits for that year and retained earnings for the preceding two years. For any insured bank, dividend payments that would endanger the bank can be restricted under the general enforcement and cease and desist powers of the federal regulators. In addition, many other regulations are phrased in terms of a percentage of a bank's capital — as, for example, total loans to a single borrower.

Restrictions on investment banking

In the 1930s, a number of restrictions were placed on the ability of banks and their affiliates to engage in investment banking and to hold stocks for their own account. Most of these restrictions were imposed in the Banking Act of 1933, which is commonly referred to as the Glass-Steagall Act.

The restrictions on investment banking activities stemmed from the 1929 stock market crash and the perceived role of some banks in the market's collapse. This separation of banking and securities activities also arose from the fear that a company engaged in both activities would experience serious conflicts of interest — conflicts that might be resolved to the detriment of bank depositors or investors. As an example, a bank might be tempted to favor its existing corporate customers by recommending their stocks to investors or by lending investors the funds to buy such stocks. In addition, a bank might face a conflict of interest in helping a loan customer issue new securities, because the funds obtained from issuing securities could go towards paying off the customer's loans. In many cases, though, these types of conflicts might be offset by a bank's desire to maintain a favorable image and reputation with its customers and in the capital markets.

In recent years, there has been a strong debate over the Glass-Steagall restrictions. This debate has centered on whether these restrictions are needed to limit potential conflicts or should be removed in the interest of bringing additional competition into securities markets and allowing banks to more fully meet customer

needs. The Gramm-Leach-Bliley Act of 1999 attempts to address these issues by allowing a broader range of securities activities in the subsidiaries of holding companies and banks, where the conflicts and risks of such activities can be more readily separated from affiliated banks and their operations. At the same time, this legislation leaves much of the framework in place that limits the investment banking activities a bank can do directly.

The Gramm-Leach-Bliley Act repeals sections 20 and 32 of the Banking Act of 1933. Section 20 had prevented member banks from affiliating with organizations “engaged principally in the issue, flotation, underwriting, public sale, or distribution of stocks, bonds, debentures, notes, or other securities.” Similarly, section 32 prohibited member banks and their officers, directors, and employees from having ties with an investment banking concern. The removal of these provisions thus gives banks an opportunity to affiliate with firms conducting a wide range of securities activities.²⁴

Before exercising these securities powers, though, a banking organization must comply with the standards contained in the Gramm-Leach-Bliley Act, including the requirement that all of its depository institution subsidiaries be well capitalized, well managed, and have at least satisfactory CRA ratings.²⁵ Organizations that elect to become financial holding companies are then authorized to underwrite, deal in, or make a market in all types of securities, including mutual funds, and must notify the Federal Reserve Board within 30 days after commencing such activities. Financial holding companies may also engage in merchant banking.²⁶ Tra-

²⁴ A bank and any other financial institution or company are held to be affiliates if they are under common control, such as might occur if a majority of directors or at least 25 percent of the ownership of both institutions or companies were in common.

²⁵ For more information on the activities and regulatory standards for financial holding companies, see pages 157–59 of this book.

²⁶ These merchant banking activities typically involve making substantial investments in companies for the purpose of selling later at an anticipated profit. Merchant bankers may help in restructuring a company for resale and setting general strategies, but do not play an active managerial role in the company. Merchant banking activities of financial holding companies must conform to regulations issued by the Federal Reserve Board and the Secretary of the Treasury (12 CFR 225, subpart J; 12 CFR 1500).

ditional bank holding companies are still restricted to securities activities that the Federal Reserve Board had approved by regulation or order prior to the 1999 legislation.

Similarly, the financial subsidiaries of national banks may engage in a number of investment banking activities beyond what banks can do. In addition to the activities authorized for banks, the financial subsidiary of a national bank may engage in all types of securities underwriting and dealing as long as the bank and its depository institution affiliates are well capitalized and well managed.²⁷ At the time the activities are begun, the national bank and each depository institution affiliate must have at least satisfactory CRA ratings. Well-capitalized state banks may establish financial subsidiaries, too, and conduct the same activities as a principal that are permissible for national bank financial subsidiaries.

In contrast to this broader authority for affiliates, the securities activities of banks are still restricted by sections 21(a)(1) and 16 of the Banking Act of 1933.²⁸ Section 21(a)(1) of this act makes it unlawful for any person or firm to engage in investment banking activities and at the same time receive demand or time and savings deposits. By investment banking activities, the act means issuing, underwriting, selling, or distributing stocks, bonds, debentures, notes, or other securities. Section 16 specifies the range of securities activities that are open to national banks. For example, national banks can buy and sell investment securities upon the order and for the account of a customer, and they can hold investment securities of their own, subject to statutory limits on individual issues and regulations of the Comptroller of the Currency. No restrictions are placed on a national bank's authority to deal in,

²⁷ 12 U.S.C. §24a. If a national bank is one of the 50 largest insured banks, it must meet an additional requirement of having at least one issue of outstanding debt that is rated in one of the three highest rating categories. A bank among the next 50 largest must also meet the same ratings standard or have a long-term issuer credit rating in the three highest categories.

²⁸ 12 U.S.C. §378, 12 U.S.C. §24(7).

underwrite, or purchase for its own account obligations of the federal government, general obligations of states and political subdivisions, and certain federal agency securities. State member banks are also subject to these same provisions.

While these sections of the 1933 act establish the general investment banking restrictions for most commercial banks, several points have been further clarified in the Banking Act of 1935. For example, the 1935 act gives state banks, trust companies, other financial institutions, and private bankers the same investment securities powers granted national banks. Additionally, the 1933 act raised questions about the ability of financial institutions to conduct stock transactions. Therefore, the 1935 legislation gives member banks the ability to purchase and sell stocks without recourse but only upon the order and for the account of customers. Member banks are specifically prohibited from holding shares of corporate stock for their own account.

The Gramm-Leach-Bliley Act further extends the securities powers of banks by giving national banks unrestricted authority to deal in, underwrite, and purchase for their own account municipal revenue bonds, provided the bank is well capitalized. The same provisions apply to state member banks if the activities are authorized as well by state law or wildcard statutes.²⁹

This legal framework establishes the general investment banking powers of banks and their affiliates. A number of regulatory agency rulings and federal court decisions over the past few decades have also helped interpret and establish the boundaries of securities powers for banks and bank holding companies in such

²⁹ The Gramm-Leach-Bliley Act, however, removes the blanket exemption that banks have had from registering as broker-dealers under the Securities and Exchange Act of 1934. Instead, the act provides a number of exemptions from registration for certain traditional banking activities that involve securities transactions (See 12 U.S.C. §78c(a)(4-5)). Banks that cannot meet these exemptions would generally have to move the noncomplying activities out of the bank and into a separate subsidiary or affiliate.

areas as securities brokerage, financial advisement, mutual fund services, and securities underwriting.³⁰ However, as banking organizations form financial holding companies and bank financial subsidiaries, the Gramm-Leach-Bliley Act will supercede many of these regulatory rulings and court decisions. In addition, banks must comply with a number of other securities laws and regulations. Depending upon the activities, a banking organization will have to comply with such laws as the Securities and Exchange Act of 1934 and the Investment Company Act of 1940 and with direct SEC supervision of securities subsidiaries.

One final area of regulatory interest with regard to bank securities activities is in disclosures to customers. In their securities operations, banking organizations must follow any applicable SEC disclosure requirements. Moreover, the federal banking agencies issued joint guidelines in 1994 to ensure that retail customers are clearly informed about the risks of nondeposit investment products. Under these guidelines, a bank must make oral and written disclosures to customers specifying that mutual funds are: (1) not insured by the FDIC, (2) not a deposit or other obligation of, or guaranteed by, the bank, and (3) subject to investment risks, including possible loss of the principal amount invested. These guidelines further contain a number of provisions relating to training and supervision of sales personnel, customer suitability recommendations, third-party arrangements, and physical separation of mutual fund and deposit operations to prevent customer confusion.

Bank relationships with affiliates

In addition to the limitations on securities affiliates and investment banking ties, several other restrictions apply to a bank's relationship with other affiliates and to the activities of affiliates. These

³⁰ For a summary of the key regulatory rulings and court decisions, see the previous edition of this book: Kenneth Spong, *Banking Regulation: Its Purposes, Implementation, and Effects* (4th Edition, Federal Reserve Bank of Kansas City), pp. 84-87.

restrictions were developed primarily in the interest of holding banking risks to a level consistent with protecting depositors and the deposit insurance system. Some of the restrictions were introduced to prevent insider abuses, avoid conflicts of interests, and limit tie-in sales to bank customers.

Activities of bank affiliates are limited by the Bank Service Corporation Act of 1962, as amended, and by the Bank Holding Company Act and its 1970 amendments. The Bank Service Corporation Act allows insured banks to organize and hold the stock of bank service corporations.³¹ These corporations may perform such routine banking services as check handling and accounting functions for depository institutions. They may also engage in any service, other than deposit taking, authorized for the parent bank or banks, provided similar geographic restrictions are followed. In addition, under the Garn-St Germain Act, bank service corporations can engage in any nondeposit-taking, nonbanking activity the Federal Reserve Board determined, by regulation, to be permissible for a bank holding company prior to November 1999. Before a bank service corporation can engage in such nonbanking activities, though, an application or notice must be sent to the Federal Reserve Board for its approval. Other bank service corporation activities require that prior notice be given to a bank's primary federal supervisor.

Under the Bank Holding Company Act and its amendments, the parent holding company of a bank can conduct a range of activities through the holding company itself or through a non-bank subsidiary. Under the Gramm-Leach-Bliley Act of 1999, traditional bank holding companies can engage in nonbanking activities that the Federal Reserve Board determined to be closely related to banking prior to November 1999. Financial holding companies can engage in the same activities as well as a broader array of financially related activities, including securities underwriting and dealing, insurance agency and underwriting activities,

³¹ 12 U.S.C. §§1861-1867.

and merchant banking. In addition, financial holding companies can engage in any activity that the Board and the Secretary of the Treasury jointly determine to be financial in nature or incidental to financial activities or that the Board determines to be complementary to financial activities without posing a substantial risk to depository institutions or the financial system. The financial subsidiary of a bank can also engage in activities that are financial in nature or incidental to such as activities, provided these activities do not involve insurance underwriting, real estate development or investment, or merchant banking.

In the interest of protecting depositors from the risk of these broader activities and preventing insider abuses and misapplication of bank funds, federal banking laws restrict transactions between insured banks and their affiliates.³² For example, credit extensions, advances, purchases of assets, or investments in a single affiliate of an insured bank are limited to 10 percent of the bank's capital stock and surplus. Other transactions included in this limit are guarantees issued on behalf of an affiliate and the acceptance of an affiliate's securities as collateral for any loan. The total of such credit extensions, investments, and other transactions involving all affiliates is limited to 20 percent of bank capital stock and surplus. These affiliate restrictions do not apply to transactions between subsidiary banks of a holding company, provided the company owns 80 percent or more of the voting stock of each bank.

Under the Gramm-Leach-Bliley Act of 1999, the restrictions on transactions with affiliates extend to the financial subsidiaries of banks. However, the 10 percent limit on transactions with an individual affiliate does not apply to transactions between a bank and a financial subsidiary. As a result, a bank may lend or invest up to 20 percent of its capital and surplus in a single financial subsidiary.

Any transactions with affiliates must further be on terms and

³² These restrictions are contained in sections 23A and 23B of the Federal Reserve Act for member banks (12 U.S.C. §§371c and 371c-1) and section 18(j)(1) of the Federal Deposit Insurance Act for nonmember insured banks (12 U.S.C. §1828(j)(1)).

under circumstances that are the same, or at least as favorable to the bank, as comparable transactions with other parties. Credit extensions must be secured according to statute. In addition, an insured bank generally cannot purchase low-quality assets from any of its affiliates. Examples of low-quality assets are classified loans and securities, assets in nonaccrual status, and past due assets. Moreover, an insured bank may not suggest in any way that it is responsible for the obligations of its affiliates.

Other restrictions apply to a bank's dealings with its affiliates. For example, certain tie-in arrangements between a bank, its holding company parent, and any subsidiaries of the holding company are prohibited by the Bank Holding Company Act Amendments of 1970. This prohibition prevents banking organizations from offering a service on the condition or requirement that a customer purchase additional services from the organization or its subsidiaries. To protect bank funds, the Federal Reserve also examines management contracts, services, personnel use, and other relationships between a bank and its holding company.

Reserve requirements

Reserve requirements were originally adopted in state and national banking systems as a liquidity measure to counter deposit drains or note conversions and to protect bank customers. This objective, however, no longer receives much attention. Emergency liquidity and public confidence are presently provided through the Federal Reserve's monetary policy and lender of last resort roles and through the deposit insurance system. Required reserves, moreover, provide little support by themselves for depositors. Deposits are only partially backed by reserves under our fractional reserve system, and many types of deposits no longer carry reserve requirements. Also, due to their required nature, a bank's reserve holdings usually are not available to meet liquidity needs. As a con-

sequence, reserve requirements are now seen mainly as a tool of monetary policy.

The Depository Institutions Deregulation and Monetary Control Act of 1980 requires all depository institutions offering transaction accounts to maintain reserves with the Federal Reserve System either directly or through other institutions.³³ Previously, only member banks were required to hold reserves at Federal Reserve banks. The 1980 act set reserve requirements at 3 percent on the first \$25 million in transaction accounts (raised to \$42.8 million for 2001) and 12 percent on greater amounts.³⁴ In April 1992, the Federal Reserve lowered the 12 percent reserve requirement to 10 percent in order to help strengthen the balance sheets of banks and put them in a better position to extend credit. Non-personal time deposits and Eurocurrency liabilities required 3 percent reserves after implementation of the 1980 legislation. However, the Federal Reserve eliminated this requirement in December 1990, leaving transaction accounts as the only type of deposit subject to required reserves. Reserves can be held in the form of vault cash, reserve balances at a Federal Reserve Bank, or pass-through accounts at a correspondent, Federal Home Loan Bank, or Central Liquidity Facility for credit unions.

Because required reserves earn no interest, they affect the earnings of banks, lowering profitability and reducing the ability of banks to compete with nondepository institutions. As a result, many banks offer repurchase agreements and sweep accounts which move funds on an overnight or weekend basis from reservable transaction accounts into investments or other deposit accounts not subject to reserve requirements. In addition, a num-

³³ Under Federal Reserve Regulation D (12 CFR 204), transaction accounts include demand deposit accounts, negotiable order of withdrawal (NOW) accounts, share draft accounts, and other accounts which allow transfers or payments to third parties.

³⁴ Under the Garn-St Germain Depository Institutions Act of 1982, the first \$2 million in reservable liabilities held by a depository institution is not subject to reserve requirements. This threshold was raised to \$5.5 million in 2001.

ber of bills have been introduced in Congress over the past few years to pay banks interest on their reserves, add such interest payments to the bank insurance fund, or allow banks more flexibility in sweeping funds out of transaction accounts.

Extensions of credit by Federal Reserve banks

When the Federal Reserve Act was passed in 1913, credit extensions by Federal Reserve banks to member banks were designed to serve two purposes. One was to provide an elastic currency and reserve base by establishing an outside source of reserves and liquidity for the banking system. In fact, a major intent of those designing the Federal Reserve System was to create a lending function that would help fund the credit needs of the economy, as well as limit or curtail banking panics and monetary disruptions. The other purpose of credit extensions was to aid banks with temporary liquidity problems. By extending short-term credit to banks with unexpected deposit drains or other problems, the Federal Reserve could help banks avoid more drastic steps, such as a hurried liquidation of loans. As a consequence, banks would have a better chance of averting situations that could worsen their condition or lessen confidence in the banking industry. These objectives still govern the Federal Reserve's lending to depository institutions.

Since the Monetary Control Act of 1980, any depository institution offering transaction accounts or nonpersonal time deposits is eligible to obtain credit from the Federal Reserve System. This credit is granted according to the rules of Federal Reserve Regulation A.³⁵ Federal Reserve lending can be in the form of short-term adjustment credit for temporary needs, seasonal credit for smaller institutions with a strong seasonal pattern in their deposits or loans, or other extended credit for those experiencing exceptional

³⁵ 12 CFR 201. The statutes authorizing Federal Reserve credit extensions include 12 U.S.C. §§343, 347, 348, 374, and 461.

circumstances and more sustained problems. In addition, the Federal Reserve may lend to individuals, partnerships, and corporations in “unusual and exigent circumstances,” but this lending authority has seldom been employed.

Federal Reserve credit is to be used only to meet a demonstrated need and for appropriate purposes. For instance, such borrowing is not to be used as a substitute for capital, to speculate in or increase investments, to provide funding for a loan expansion program, or to take advantage of discount rates whenever they are more favorable than rates on competing sources. Also, borrowing requests are not to be initiated until all other sources of funds have been exhausted, including any special industry lenders.

A Reserve Bank can extend credit either through advances secured by acceptable collateral or through the discount of eligible paper, although discount borrowing is seldom used. Collateral for advances includes U.S. Government and agency securities; acceptable quality state and local government securities; mortgage notes covering one- to four-family residences; and business, consumer, and other customer notes. Federal Reserve banks set the basic rate for advances and discounts subject to review and approval by the Board of Governors. Flexible rates are charged for seasonal credit and for other extended credit provided for more than 30 days. These rates take into account the rates on market sources of funds and are always equal to or greater than the basic discount rate.

In addition to these requirements, borrowing by troubled institutions must meet a number of other standards introduced in the Federal Deposit Insurance Corporation Improvement Act of 1991. The intent of these provisions is to curtail lending to failing institutions, particularly if the lending would serve to delay timely resolution of their problems and, as a result, cause greater losses for the FDIC. Undercapitalized institutions may not borrow for more than 60 days in any 120-day period unless their federal banking supervisor or the chairman of the Federal Reserve Board certifies them as viable. For critically undercapitalized institutions, this

lending period only extends for the first five days after they become critically undercapitalized. The Federal Reserve could choose to lend beyond these bounds, but the System would be liable for added losses the FDIC might experience in the event the institution failed.

Apart from borrowing from the Federal Reserve, an insured bank is eligible for membership in a Federal Home Loan Bank (FHLB) and, accordingly, access to its cash advance program.³⁶ FHLB lending to the banking industry has expanded rapidly in recent years, and this trend promises to continue as a result of provisions in the Gramm-Leach-Bliley Act of 1999 which expand the number of banks eligible for membership in the FHLB system and broaden the purposes for which advances may be used. To become a member, a bank must have at least 10 percent of its assets in residential mortgage loans or have less than \$500 million in total assets (a “community financial institution”). Banks also must meet certain standards regarding financial condition, character of management, and home financing policies. Membership and borrowing further require a bank to purchase Federal Home Loan Bank stock in proportion to its asset size and the amount of advances it receives.

Long-term advances from FHLBs must serve one of two purposes: providing funds for residential housing finance or providing funds to community financial institutions for lending to small businesses, small farms, and small agri-businesses. These advances must be fully secured by current first residential mortgages or related securities; certain other low-risk, real estate-related collateral; U.S. Government or agency securities; deposits at a Federal Home Loan Bank; or, in the case of community financial institutions, secured loans for small business and agricultural purposes or related securities. FHLBs also have community investment and affordable housing programs that are designed to provide lower-rate advances to member institutions for financing housing and

³⁶ 12 U.S.C. §1424, 12 U.S.C. §1430.

community development for low- and moderate-income households and neighborhoods.

Deposit interest rate limitations for insured institutions

Interest rate ceilings on time and savings deposits and the interest rate prohibition on demand deposits were legislated after the banking panics in the early 1930s. Although the rationale was not widely discussed then, interest controls were presumably adopted as a means of limiting interest rate competition among banks, thus raising bank profitability while reducing risks. Interest ceilings were extended to insured savings and loan associations in 1966 in an effort to keep their interest costs in line with the yields on their mortgage portfolios. Rate ceilings were set higher for savings and loans than for commercial banks to support a continued flow of funds to housing and thus avoid any liquidity crisis for institutions holding long-term mortgages.

Beginning with the 1970s, however, the effect of interest rate controls was more adverse than favorable. Ceilings hindered depository institutions in competing with less regulated institutions that could offer higher rates for funds. Interest controls also appeared to have no favorable effect on bank profitability. With ceilings, banks were forced to use many indirect and often inefficient methods of competing for deposits. Consequently, interest rate ceilings had come to be viewed as a hindrance to competition and of little help in controlling banking risks. In addition, by reducing returns on deposits, controls may have done more to harm depositors than to protect them.

The Monetary Control Act was passed in 1980 with a six-year phase-out of interest rate controls for time and savings deposits. The act established the Depository Institutions Deregulation Committee (DIDC) and directed that interest rate ceilings be phased out as rapidly as economic conditions would permit. The

interest ceilings on time and savings deposits were subsequently moved to less restrictive levels and then eliminated in a series of steps. On April 1, 1986, the final step was taken when the ceiling on savings deposits was removed.

As a result of these steps, only the terms on demand deposits remain regulated, with a statutory prohibition against any interest payments on such accounts. Depository institutions now have the freedom to select the interest rates they will pay on time and savings deposits, provided they remain well capitalized. For other institutions, the Federal Deposit Insurance Corporation Improvement Act of 1991 imposes a number of constraints on deposit interest rates. Undercapitalized institutions may not solicit deposits by offering a rate that is more than 75 basis points above the prevailing rate paid on comparable deposits. Significantly undercapitalized institutions, as well as any undercapitalized institution that fails to submit and implement a capital restoration plan, generally must restrict deposit rates to prevailing market rates, and a critically undercapitalized bank cannot pay rates on new or renewed liabilities that would bring its average cost of funds significantly above market rates. Other rate limitations apply to brokered deposits.

Brokered deposits

Brokered deposits refer to deposits placed in depository institutions by third-party sources rather than directly by the depositor. Ideally, such deposits provide for a more optimal flow of funds within the banking system, particularly if deposit brokers can help depositors find the highest rates available for their funds, while channeling funds to institutions with the best use for them.

Much of the significant expansion in brokered deposits during the 1980s, however, did not closely adhere to this market ideal. In particular, brokered deposits became a convenient funding vehicle for some problem thrifts and banks, as they sought to cover their

losses and quickly reverse their declines through speculative strategies and rapid growth. These institutions, by offering higher rates than others, were able to attract significant amounts of brokered deposits. Moreover, their adverse condition put little constraint on such funding, since brokers commonly divided large deposits among enough institutions to maintain full insurance coverage. This brokered funding thus subverted many of the normal market constraints on problem institutions and kept such institutions from having to curtail highly risky activities.

To monitor the use of brokered deposits and lessen potential deposit insurance losses, federal banking agencies instituted quarterly reporting requirements on brokered deposits in 1983. These were supplemented a year later with more frequent reporting by banks having significant levels of brokered deposits. Examinations and enforcement actions have also been used to detect and control abuses of brokered deposits.

The most comprehensive steps to regulate the use of brokered deposits, however, took place in 1989 and 1991. Congress gave the FDIC formal authority in 1989 to prohibit troubled institutions from accepting brokered deposits. These standards were further tightened in the Federal Deposit Insurance Corporation Improvement Act of 1991.

Under the implementing regulations, only institutions that are well capitalized according to the prompt corrective action capital standards may solicit, accept, or renew brokered deposits without any restrictions.³⁷ Adequately capitalized institutions must apply for and receive a waiver from the FDIC before entering the brokered deposit market. Also, the rates they pay for such deposits cannot be significantly higher than (within 75 basis points of) the prevailing rates on similar deposits in their market area or a national rate for deposits accepted from outside this area.

Undercapitalized institutions may not use brokered deposits.

³⁷ 12 CFR 337.6, as it implements 12 U.S.C. §§1831f, 1831f-1.

The only exception to this is for an institution that has been under FDIC conservatorship for less than 90 days, provided the deposits would not harm the institution and would help it meet its obligations. The brokered deposit regulations generally require deposit brokers to register with the FDIC and to maintain records on the deposits they place. As a result of these restrictions, sound institutions can continue to use brokered deposits as a means of channeling funds according to market needs. Problem institutions, however, will not be able to rely on brokered deposits and higher deposit rates to support or expand their operations.

Off balance sheet items

In addition to the exposure within a bank's portfolio, risk can also be affected by commitments that are not directly reflected on a bank's balance sheet. Some examples of the many contingent liabilities and commitments in banking are:

- Commercial letters of credit
- Standby letters of credit
- Lawsuits
- Repurchase agreements
- Loan commitments
- Futures, forward, and standby contracts for securities
- Commitments to buy and sell foreign exchange
- Interest rate swap agreements

Several regulatory means are used to estimate or control the risk from off balance sheet commitments. Some commitments, for example, are prohibited by law. Others are regulated through the supervisory and examination process and monitored through reporting requirements. Many off balance sheet items must also be backed by capital under the risk-based capital requirements.

Finally, bankers must be aware of the regulations that apply if a commitment results in a balance sheet item.

Bank examiners try to derive the amount of a bank's contingent liabilities and assess the possible risks of these items. They also review any formal policies and guidelines that a bank has for granting letters of credit, making loan commitments, entering into foreign exchange contracts, or trading interest rate futures contracts. Bank supervisors expect bankers to apply the same credit analysis and lending policies to letters of credit as would be applied to bank loans.

Regulatory agencies have established their own policies, guidelines, and interpretations for bank involvement in foreign exchange and interest rate futures contracts. Supervisory policies usually view futures contracts as appropriate when the contracts are used to hedge or lower the risk of a bank's position in these markets. On the other hand, regulators strongly discourage banks from futures activities that would increase risk and primarily involve speculation on future movements in interest or exchange rates. With the recent and rapid growth in various derivative instruments at larger banks, bank regulators also are starting to pay very close attention to the level of management oversight given to these activities and to the expertise of a bank's staff in judging and limiting the bank's risk exposure.

Reporting requirements have become more important over the last decade in monitoring and controlling the use of off balance sheet items in banking. Such requirements had previously been minimal. Prior to the 1980s, most bankers had few significant contingent liabilities, and those they had were usually short-term, low-risk commitments, such as commercial letters of credit. However, with the growth in repurchase agreements, loan commitments, standby letters of credit, foreign exchange trading, and interest rate swaps and futures contracting, the need has increased for reporting these commitments to stockholders and bank regulators. Since 1983, all banks must report on each major category

of commitments and contingencies. This report is filed as a separate schedule in the quarterly Report of Condition.

Because banks may eventually have to meet their commitments, supervisory policies and balance sheet regulation can also affect bank commitments. Examples of this include limits on loans to a single borrower, credit evaluations, and restrictions on eligible bankers acceptances.

Other regulations for depositor protection

Among the other regulations designed to protect depositors and control banking risks is the Bank Protection Act of 1968, which is implemented for a bank by its primary federal supervisor. This act sets minimum standards for security and protection devices and for the security procedures of insured banks. As a means of encouraging liquidity and keeping banks out of the real estate business, section 24A of the Federal Reserve Act limits a member bank's investment in its premises.³⁸ This investment must either be approved by the member bank's primary federal supervisor, be no more than the bank's capital and surplus, or, for banks that have a CAMELS composite rating of '1' or '2' and are well capitalized, be no more than 150 percent of capital and surplus. Other regulations and supervisory policies govern such activities and items as bank insurance activities, director and management qualifications, and deposits of public funds in banks.

In addition, under the Federal Deposit Insurance Corporation Improvement Act of 1991, as amended, the three federal banking agencies were required to issue safety and soundness guidelines containing standards for such banking factors as internal controls and audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, and compensation.³⁹ Provi-

³⁸ 12 U.S.C. §371d.

³⁹ These interagency guidelines appear at 12 CFR 30 for national banks, 12 CFR 263 for state member banks, and 12 CFR 308, subpart R, for state nonmember banks.

sions of this act also attempt to limit the exposure that a bank might have to other depository institutions through correspondent transactions and credit relationships.⁴⁰

SUPERVISORY COMPLIANCE PROCEDURES

The principal supervisory procedures used to check compliance with banking regulations and protect depositors fall under the categories of bank examinations, bank holding company inspections, reporting requirements, surveillance systems, enforcement actions, and FDIC assessments and policies. In addition to these supervisory procedures, many banks and holding companies must also submit an annual report to federal and state banking agencies containing annual financial statements, statements by bank management, and an independent public accountant's report. Many aspects of these supervisory methods have already been discussed in terms of the particular banking activities they affect. Consequently, this section looks at the operational aspects of supervision and the framework used to develop an overall view of a bank and its ability to protect depositors.

Bank examinations

Bank examinations are used to collect on-the-spot information that will indicate the current financial condition of a bank and its compliance with applicable laws and regulations. As shown in Figure 1, all phases of a bank's operations are covered in an examination, and special reviews are made of trust activities, electronic data processing operations, and compliance with consumer protection laws. An examination thus provides a comprehensive picture of a bank's operations and financial performance. Bank exams, though, do not serve as audits. Examiners confine themselves to evaluating

⁴⁰ These provisions are implemented through Federal Reserve Regulation F (12 CFR 206).

only the activities and bank records that are necessary to judge a bank's condition and regulatory compliance. Generally, the scope of an examination is limited to the bank's records and does not include verifying all of the bank's asset and liability account balances.

To help reduce supervisory burden further, make better use of examiner resources, and take a more forward-looking approach, the banking agencies began developing a new supervisory framework in the mid-1990s. The key element in the new framework is bank examinations that focus more closely on the areas of greatest risk to a particular bank. This risk-focused examination process requires examiners to first perform a risk assessment of a bank before beginning any on-site supervisory activities. Risk assessments involve identifying the significant activities of a bank, determining the risks inherent in these activities, and undertaking a preliminary assessment of the processes a bank has in place to identify, measure, monitor, and control these risks. Examiners then use a bank's risk assessment to direct their examination efforts toward the areas of greatest risk to the institution. For banks with sound risk-management processes, examiners can rely more heavily on a bank's own internal risk assessments rather than having to perform extensive supervisory tests.

Federal bank supervisors review six critical aspects of a bank's operations and condition in their examination rating procedure, commonly called the CAMELS rating system. The aspects are:

- Capital adequacy
- Asset quality
- Management and administrative ability
- Earnings level and quality
- Liquidity level
- Sensitivity to market risk

Banks are rated from '1' to '5' on each of these aspects. A '1' is the highest rating and indicates the strongest performance, best

Figure 1

**COMMERCIAL BANK REPORT
OF EXAMINATION**



Name: _____ Examination Date: _____

Location: _____ Examination Start Date: _____

RSSD ID Number: _____

THIS REPORT OF EXAMINATION IS STRICTLY CONFIDENTIAL

This report has been prepared by an examiner selected or approved by the Board of Governors of the Federal Reserve System. The report is the property of the Board of Governors and is furnished to directors and management for their confidential use. The report is strictly privileged and confidential under applicable law, and the Board of Governors has forbidden its disclosure in any manner without its permission, except in limited circumstances specified in the law (12 U.S.C. 1817(a) and 1831(m)) and in the regulations of the Board of Governors (12 C.F.R. 261.11). Any unauthorized disclosure of the report may subject the person or persons disclosing or receiving such information to the penalties of Section 641 of the U.S. Criminal Code (18 U.S.C. 641).

Each director or trustee, in keeping with his or her responsibilities, should become fully informed regarding the contents of this report. In making this review, it should be noted

that this report is not an audit, and should not be considered as such. Management is required by law to send a copy of this report to independent auditors engaged to conduct audits of the institution. Under no circumstances should the directors, officers, employees, trustees or independent auditors disclose or make public this report or any portion thereof except in accordance with applicable law and the regulations of the Board of Governors.

The information contained in this report is based upon the books and records of the bank, upon statements made to the examiner by directors, officers, and employees, and upon information obtained from other sources believed to be reliable and presumed by the examiner to be correct.

FEDERAL RESERVE BANK OF KANSAS CITY

Note: This figure is referenced on page 116.

Figure 1, *continued*

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<p>MESSAGE TO THE BOARD OF DIRECTORS/TRUSTEES: This Report of Examination consists of three major sections, Conclusions and Recommendations, Assessment, and Supplemental Information. The Conclusions and Recommendations section contains the examination conclusions and comments. The Assessment section contains an analysis of management, asset quality, capital, earnings, sensitivity to market risk, liquidity, and risk management. The Supplemental Information section contains financial schedules which support corresponding pages.</p>	
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risk-management practices, and least degree of supervisory concern. On the other hand, a '5' is the lowest rating and implies the weakest performance, inadequate risk-management practices, and highest level of supervisory concern. In making these ratings, examiners follow many of the procedures discussed earlier in this chapter. A bank's performance in these categories is then compared with the performance of other banks operating under similar circumstances.

Capital ratings, for example, partly reflect how a bank's capital compares to the capital of other banks and to established capital standards. In rating capital at a particular bank, though, examiners assess whether the bank is maintaining capital commensurate with the nature and extent of risks it assumes and whether bank management has the ability to identify, measure, monitor, and control these risks. Among the individual factors examiners use to assess capital adequacy are the level and quality of capital; ability of management to address the need for additional capital; the nature, trend, and volume of problem assets; adequacy of loan loss allowances; balance-sheet composition and inherent risks; and risk of off balance sheet activities. Other factors considered by examiners are the quality and strength of bank earnings, reasonableness of dividends, prospects and plans for growth, and access to capital markets and other sources of capital.

Asset quality ratings are determined by the amount of existing and potential credit risk associated with the loan and investment portfolios, other real estate owned, and other assets and off balance sheet transactions. In particular, examiners assess such factors as the adequacy of a bank's loan underwriting standards and loan and investment policies; the volume and severity of problem, classified, and nonperforming assets; adequacy of loan loss allowances; and existence of asset concentrations and degree of diversification in the loan and investment portfolios.

Management ratings are assessed according to the capability of a bank's board of directors and management to identify and control the bank's risk exposure and to ensure safe, sound, and effi-

cient banking operations in compliance with applicable laws and regulations. This capability is rated according to the level and quality of oversight the board of directors and management provides; ability to plan for and respond to emerging risks; and adequacy of internal policies, controls, audits, and information and risk-monitoring systems. Examiners also look at many other management aspects, including regulatory compliance, management succession plans, avoidance of self-dealing, willingness to serve the community, and the overall performance of the bank.

A bank's earnings rating is based on the level and trend of its earnings, adequacy of earnings for supplying internal capital and meeting possible loan losses, quality and sources of earnings, level of expenses, adequacy of budgeting and forecasting processes, and the exposure of earnings to various risks. In rating bank earnings, examiners typically compare a bank's returns to those of similar banks ("peer banks") in order to assess whether a bank is achieving above or below average profitability.

Liquidity is rated according to whether an institution can maintain a level of liquidity sufficient to meet its financial obligations in a timely manner, while fulfilling the banking needs of its community. Banks are expected to meet liquidity needs through such means as maintaining their deposit base, holding assets that are readily convertible into cash, having access to money markets and other funding sources, diversifying funding sources, securitizing assets, and following effective funds-management practices.

Ratings for a bank's sensitivity to market risk are based on the degree to which changes in interest rates, foreign exchange rates, commodity prices, or equity prices would adversely affect the bank's earnings or the value of its capital. Examiners further assess the ability of management to measure and control these exposures, as well as the nature and complexity of such risks.

Once ratings are assigned to each of these six categories, examiners combine the ratings to form a composite rating for the bank. In the process, examiners weight each category by its relative

importance to the bank's overall condition and the interrelationship with the other ratings components. Other factors influencing a bank's condition may also be considered. This composite rating thus reflects a bank's overall condition and indicates which banks are sound and capable of withstanding economic fluctuations, and which banks are weak and require corrective action and close supervisory attention. The banking agencies disclose the composite and component ratings to a bank's board of directors and senior management and also provide a written report of the examination.

The frequency with which banks are examined varies somewhat according to their size and condition. Under federal law, banks must have a full-scope, on-site examination at least once every 12 months. This schedule, though, can be extended to 18 months for banks with total assets under \$250 million, provided these banks are judged to be well capitalized under the prompt corrective action capital standards, were found to be well managed at the most recent examination, are not subject to formal enforcement actions, and have not experienced a change in control during this period. The banks must also have been rated outstanding or good (satisfactory) at their last examination (a CAMELS composite rating of 1 or 2). Problem institutions are typically examined on a more frequent basis, with many examined as often as twice a year.

For banking organizations with more than one bank, the federal agencies, whenever possible, coordinate their examination schedules so that all of the banks are examined within much the same time frame. Moreover, Congress directed the agencies to develop a system by 1996 for deciding which agency will have lead examination responsibilities for a particular banking organization. The agencies have continued to work jointly to improve the coordination of examinations and supervision of institutions subject to multiple regulators and to develop common examination data bases and information systems. This coordination is becoming even more essential with the ongoing consolidation among major

banks and large complex banking organizations and with the emergence of financial holding companies that can conduct a broad range of financial activities.

State banking departments have their own examination procedures and schedules for state-chartered banks. To ease the examination burden and reduce supervisory overlap, state banking departments often share their state bank examination responsibilities with the FDIC and the Federal Reserve. This sharing might take the form of alternating examinations with the appropriate federal agency or performing joint or concurrent examinations with that agency.

Bank holding company inspections

Since the financial condition of a bank holding company or any of its subsidiaries might adversely affect the operations of subsidiary banks, the Federal Reserve assesses or inspects the condition of bank holding companies and financial holding companies. Much like the bank examination process, holding company inspections have become more risk focused, with more resources devoted to major organizations and to the more notable risk exposures. Bank holding company inspections are directed mainly at the relationships that could be detrimental to subsidiary banks, and the holding companies are expected to serve as a source of financial and managerial strength to their banking subsidiaries.

The major aspects of an inspection include an assessment of the financial condition of the parent organization, its banking subsidiaries, and any nonbanking subsidiaries; a review of intercompany transactions and relationships; an evaluation of the current performance of the company and its management; and a check of the company's compliance with applicable laws, regulations, and commitments made to the Federal Reserve. While recent examination reports provide the main source of information on banking subsidiaries and other regulated affiliates, on-site evaluations are

often made of the financial condition of the bank holding company itself and significant nonbank subsidiaries.

Steps taken in a holding company inspection to review such items as assets, earnings, capital, and management are similar to that of a bank examination. However, particular attention is given to the level of debt carried by a bank holding company, the potential payment demands the debt places on bank earnings, and the success of the holding company in servicing its debt. All financial and managerial aspects of a bank holding company and its overall condition then are summarized and assigned a rating under the BOPEC rating system.

This rating system specifically looks at five aspects of a bank holding company's performance and condition:

- Bank subsidiaries
- Other (nonbank) subsidiaries
- Parent company
- Earnings consolidated
- Capital adequacy consolidated

Much like bank examination ratings, a company is rated from '1' (best) to '5' (weakest) on each of these aspects. The first three elements listed above are rated according to their contribution to the company's fundamental soundness. Consolidated earnings and capital adequacy are also important elements in the BOPEC rating system because of their critical role in the financial strength and support provided to the entire organization.

In addition to these five elements, a company is given a composite rating, which consists of both a financial and a managerial component. The financial composite rating reflects a company's overall performance under the five BOPEC elements and is measured on the same scale of '1' to '5'. The managerial composite rating is based on a comprehensive evaluation of a company's management as determined by management's role in banking,

nonbanking, and parent company operations. This rating is either an 'S', 'F', or 'U', depending on whether management is judged to be satisfactory, fair, or unsatisfactory.

The Federal Reserve's general approach and procedures in a holding company inspection can vary considerably, depending on the type of organization and its activities. For a large complex banking organization, many other authorities may be involved in the supervision of the affiliated banks and other subsidiaries.⁴¹ Consequently, the Federal Reserve must work closely with these agencies to coordinate supervisory plans, examinations and inspections, discussions with bank and holding company management, and any necessary enforcement actions. This coordinated supervision is becoming more specialized and tailored to individual organizations, and inspections and examinations are now more of a continuous process over the supervisory cycle. As an example, the supervision of large complex organizations often takes the form of a series of targeted examinations, which track individual business lines and risk exposures as they extend across the entire organization. These targeted reviews can then be incorporated into an overall assessment of the consolidated organization and its risk management practices.

In the case of financial holding companies, a number of other considerations are also important. As the "umbrella supervisor" of financial holding companies, the Federal Reserve Board has authority to supervise the overall organization. The Gramm-Leach-Bliley Act of 1999, however, imposes several limits on these supervisory powers. For instance, the Federal Reserve may not directly examine a financial subsidiary that is regulated by another authority, except under certain circumstances. Instead, the Federal

⁴¹ Large complex banking organizations are generally those with a broad range of products and activities, operations that spread across multiple supervisory jurisdictions, and consolidated assets of \$1 billion or more. In addition, these organizations are often structured and managed along business lines or functions that may spread across a number of different subsidiaries or legal entities, making close supervisory coordination critical in evaluating overall risk exposures.

Reserve must, to the fullest extent possible, rely on the examination reports of the other regulators and any information a financial subsidiary provides to the public and its direct supervisor. The Federal Reserve, moreover, is limited in its ability to impose capital requirements on regulated financial subsidiaries, take enforcement actions against such subsidiaries, or require financial subsidiaries to assist their depository institution affiliates.

The frequency of holding company inspections depends on the size and condition of a holding company and the complexity of its debt structure and nonbanking activities. Companies with more than \$150 million in consolidated assets and that also have public debt or significant nonbank lending activities receive a full-scope inspection on an annual basis.⁴² In addition to this, the Federal Reserve typically undertakes a limited-scope or targeted inspection each year for major banking organizations and for other large organizations with serious problems. Smaller organizations are inspected on a less frequent basis unless holding company problems, adverse financial information, or ownership changes warrant closer attention. Furthermore, for companies that have less than \$1 billion in assets, no public debt, and no significant nonbanking activities, Federal Reserve examiners are to perform a risk assessment, utilizing previous examination and inspection reports, other regulatory reports, and off-site surveillance information. These assessments can take the place of a full-scope inspection, provided no major concerns or problems are identified.

Reporting requirements

Banks must file various reports with their supervisors. Some reports, such as on insider loans, are used for specific regulatory

⁴² The inspection of larger holding companies, if possible, coincides with the examination of a company's "lead" or most important subsidiary bank. Also, for large complex organizations, more frequent targeted reviews are often used as a substitute for annual, full-scope inspections.

objectives, while others inform bank supervisors of a bank's current condition and performance. Since the Report of Condition is a balance sheet of a bank, it is the basic report for supervisory purposes and provides the deposit information used for FDIC insurance assessments. Collected quarterly from all banks, the report provides a breakdown of a bank's assets, liabilities, capital accounts, and off balance sheet activities on the last banking day of each quarter (See Figure 2 for the main schedule of the Report of Condition). The Report of Income lists a bank's revenues, expenses, and net income, as well as such items as dividends and contributions to capital. This report is also required quarterly (See Figure 3 for the main schedule of the Report of Income).⁴³ Other reports are required for such purposes as calculating reserve requirements, regulating bank holding company operations and foreign banking activities, and tracking changes in such areas as ownership and management structure, financial holding company activities, foreign lending exposures, and insider lending. In addition, problem institutions may be asked by their primary supervisor to file special reports on their overall condition and progress in restoring capital or improving asset quality.

Most bank reports are also available to the public and serve to give investors and bank customers information on a bank's operations and performance. This information is particularly important for the major customers of a bank and for bank stockholders, note-holders, or holding company investors as they try to protect their financial interests and make new investment choices. Because such individuals can exert a strong influence on the operation of a bank, bank supervisors, as well as many investors, continue to examine means to further increase public disclosure in banking. Greater disclosure, in fact, could expand the role that private parties and bank reporting play in achieving supervisory objectives. In partic-

⁴³ Beginning March 31, 2001, banks with domestic offices only will all file the same Report of Condition and Income. Banks with both domestic and foreign offices will file a slightly different report.

Figure 2

Legal Title of Bank

City

State

Zip Code

FDIC Certificate Number

FFIEC 041

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Consolidated Report of Condition for Insured Commercial and State-Chartered Savings Banks for March 31, 2001

All schedules are to be reported in thousands of dollars. Unless otherwise indicated, report the amount outstanding as of the last business day of the quarter.

Schedule RC—Balance Sheet

Dollar Amounts in Thousands					C300			
					RCCN	BI	MI	Thou
ASSETS								
1. Cash and balances due from depository institutions (from Schedule RC-A):								
a. Noninterest-bearing balances and currency and coin ¹					0081			1.
b. Interest-bearing balances ²					0071			1.b.
2. Securities:								
a. Held-to-maturity securities (from Schedule RC-B, column A)					1754			2.a.
b. Available-for-sale securities (from Schedule RC-B, column D)					1773			2.b.
3. Federal funds sold and securities purchased under agreements to resell					1350			3.
4. Loans and lease financing receivables (from Schedule RC-C):								
a. Loans and leases held for sale					5369			4.a.
b. Loans and leases, net of unearned income					XXXX			4.b.
c. LESS: Allowance for loan and lease losses					3123			4.c.
d. Loans and leases, net of unearned income and allowance (Item 4.b minus 4.c)					XXXX			4.d.
5. Trading assets (from Schedule RC-D)					3545			5.
6. Premises and fixed assets (including capitalized leases)					2145			6.
7. Other real estate owned (from Schedule RC-M)					2150			7.
8. Investments in unconsolidated subsidiaries and associated companies (from Schedule RC-M)					2130			8.
9. Customers' liability to this bank on acceptances outstanding					2155			9.
10. Intangible assets:								
a. Goodwill					3163			10.a.
b. Other intangible assets (from Schedule RC-M)					XXXX			10.b.
11. Other assets (from Schedule RC-F)					2160			11.
12. Total assets (sum of items 1 through 11)					2170			12.

¹ Includes cash items in process of collection and unposted debits.
² Includes time certificates of deposit not held for trading.

Note: This figure is referenced on page 127.

Figure 2, continued

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Schedule RC—Continued

Dollar Amounts in Thousands				RCON	BI	MI	Thou	
LIABILITIES								
13. Deposits:								
a. In domestic offices (sum of totals of columns A and C from Schedule RC-E)				2200				13.a.
(1) Noninterest-bearing ¹				6631				13.a.(1)
(2) Interest-bearing				6636				13.a.(2)
b. In foreign offices, Edge and Agreement subsidiaries, and IBFs								
(1) Noninterest-bearing								
(2) Interest-bearing								
14. Federal funds purchased and securities sold under agreements to repurchase				2800				14.
15. Trading liabilities (from Schedule RC-D)				3548				15.
16. Other borrowed money (includes mortgage indebtedness and obligations under capitalized leases) (from Schedule RC-M)				XXXX				16.
17. Not applicable								
18. Bank's liability on acceptances executed and outstanding				2920				18.
19. Subordinated notes and debentures ²				3200				19.
20. Other liabilities (from Schedule RC-G)				2930				20.
21. Total liabilities (sum of items 13 through 20)				2948				21.
22. Minority interest in consolidated subsidiaries				3000				22.
EQUITY CAPITAL								
23. Perpetual preferred stock and related surplus				3838				23.
24. Common stock				3230				24.
25. Surplus (exclude all surplus related to preferred stock)				3839				25.
26. a. Retained earnings				3632				26.a.
b. Accumulated other comprehensive income				XXXX				26.b.
27. Other equity capital components				XXXX				27.
28. Total equity capital (sum of items 23 through 27)				3210				28.
29. Total liabilities, minority interest, and equity capital (sum of items 21, 22, and 28)				3300				29.
Memorandum								
To be reported with the March Report of Condition.								
1. Indicate in the box at the right the number of the statement below that best describes the most comprehensive level of auditing work performed for the bank by independent external auditors as of any date during 2000				RCON	Number			
				6724		M.1.		
2 = Independent audit of the bank's parent holding company conducted in accordance with generally accepted auditing standards by a certified public accounting firm which submits a report on the consolidated holding company (but not on the bank separately)				4 = Directors' examination of the bank conducted in accordance with generally accepted auditing standards by a certified public accounting firm (may be required by state chartering authority)				
3 = Attestation on bank management's assertion on the effectiveness of the bank's internal control over financial reporting by a certified public accounting firm				5 = Directors' examination of the bank performed by other external auditors (may be required by state chartering authority)				
				6 = Review of the bank's financial statements by external auditors				
				7 = Compilation of the bank's financial statements by external auditors				
				8 = Other audit procedures (excluding tax preparation work)				
				9 = No external audit work				

¹ Includes total demand deposits and noninterest-bearing time and savings deposits.
² Includes limited-life preferred stock and related surplus.

Figure 3, continued

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Schedule RI—Continued

Dollar Amounts in Thousands		Year-to-date				
		RIAD	BI	MI	Thou	
3. Net interest income (item 1.h minus 2.e)					4074	3.
4. Provision for loan and lease losses					4230	4.
5. Noninterest income:						
a. Income from fiduciary activities	4070					5.a.
b. Service charges on deposit accounts	4080					5.b.
c. Trading revenue ¹	A220					5.c.
d. Investment banking, advisory, brokerage, and underwriting fees and commissions	XXXX					5.d.
e. Venture capital revenue	XXXX					5.e.
f. Net servicing fees	XXXX					5.f.
g. Net securitization income	XXXX					5.g.
h. Insurance commissions and fees	XXXX					5.h.
i. Loan and other credit-related fees	XXXX					5.i.
j. Net gains (losses) on sales of loans	5416					5.j.
k. Net gains (losses) on sales of other real estate owned	XXXX					5.k.
l. Net gains (losses) on sales of other assets (excluding securities)	XXXX					5.l.
m. Other noninterest income*	XXXX					5.m.
n. Total noninterest income (sum of items 5.a through 5.m)					4079	5.n.
6. a. Realized gains (losses) on held-to-maturity securities					3521	6.a.
b. Realized gains (losses) on available-for-sale securities					3196	6.b.
7. Noninterest expense:						
a. Salaries and employee benefits	4135					7.a.
b. Expenses of premises and fixed assets (net of rental income) (excluding salaries and employee benefits and mortgage interest)	4217					7.b.
c. Amortization expense of intangible assets (excluding goodwill)	XXXX					7.c.
d. Other noninterest expense*	4092					7.d.
e. Total noninterest expense (sum of items 7.a through 7.d)					XXXX	7.e.
8. Income (loss) before income taxes, goodwill charges, extraordinary items, and other adjustments (item 3 plus or minus items 4, 5.n, 6.a, 6.b, and 7.e)					XXXX	8.
9. Applicable income taxes (on item 8)					XXXX	9.
10. Income (loss) before goodwill charges, extraordinary items, and other adjustments (item 8 minus 9)					XXXX	10.
11. Goodwill charges					XXXX	11.
12. Income (loss) before extraordinary items and other adjustments (item 10 minus item 11)					4300	12.
13. Extraordinary items and other adjustments, net of income taxes*					4320	13.
14. Net income (loss) (sum of items 12 and 13)					4340	14.

* Describe on Schedule RI-E—Explanations

¹ For banks required to complete Schedule RI, Memorandum item 8, trading revenue reported in Schedule RI, item 5.c, must equal the sum of Memorandum items 8.a through 8.d, column B.

ular, banking supervisors and others have been looking at ways to improve disclosures on asset quality and concentrations, other significant risk exposures, derivative instruments, various off balance sheet activities of banks, and the fair market value of major banking assets and liabilities.

Apart from supervisory reports, banks must also file Bank Secrecy Act reports on large currency transactions with customers.⁴⁴ These Currency Transaction Reports are routinely used by the Treasury Department and Internal Revenue Service in various criminal and tax investigations and prosecutions. The reports have most prominently been associated with attempts to track money laundering from the drug trade and other illegal activities.

Under the Bank Secrecy Act, banks must file a report on each single or multiple currency transaction totaling \$10,000 or more. Banks, though, are not required to file reports on transactions with other depository institutions, U.S. governmental or state authorities, and certain types of businesses where the reports would have little law enforcement value. Depending on the circumstances, banks may also be able to exempt customary transactions with selected businesses and with established customers that appear to be conducting legitimate operations. Banks are to report any suspicious transactions even though they may not fall within the reporting standards.

Surveillance and early warning systems

Federal bank supervisors use surveillance and early warning systems to monitor a bank's condition and performance between examinations and indicate when special examinations or emergency measures might be necessary. These surveillance systems are constructed primarily from previous examination information and the regular reports filed by banks and bank holding companies. In

⁴⁴ 31 U.S.C. §§5311-5324, 31 CFR 103.

general, the systems calculate a number of financial ratios, including capital ratios, disaggregated asset and liability ratios, and income ratios. Statistical comparisons are then made between the financial ratios and trends for a particular bank and those of other banks in order to judge whether that bank's condition is improving or declining.

Bank surveillance and monitoring efforts are also beginning to take advantage of various market measures of bank conditions, including bank stock prices, debt yields and ratings, and rates on uninsured deposits. Changes and volatility in these measures can thus provide valuable insights into how investors and other market participants view a bank's prospects.

Given the large resource requirements of on-site examinations, surveillance systems will continue to be important in monitoring banks between examinations and in scheduling the next examination. Surveillance and monitoring systems could play an even larger role in the future to the extent that bank disclosures become more detailed and regulators find ways to incorporate a wider range of information into the surveillance process.

Enforcement actions and penalties

The federal banking agencies can initiate a number of enforcement actions and penalties to direct banks, holding companies, and their management to correct problems and prevent further deterioration. In general, the federal agency supervising the institution or company has the authority to pursue enforcement actions. However, the FDIC has backup enforcement powers for any insured institution and may recommend that an institution's primary supervisor take enforcement steps. Under certain conditions, the FDIC may even initiate such steps itself, provided the primary supervisor fails to do so or an emergency situation exists.

Although the agencies differ somewhat in their use of the various actions, enforcement steps are most commonly taken for one

of two reasons. First, an institution may be undercapitalized, and its federal supervisor will issue a directive under the prompt corrective action guidelines.⁴⁵ Second, enforcement actions may be pursued after unsafe, unsound, or illegal practices are detected during a bank examination or holding company inspection or in response to other information. Such practices might include poor loan administration, abnormal risk taking, weak management, excessive dividend payments, and violations of banking laws. The severity of these practices will govern the type of action taken.

For banking problems that are not severe and do not involve abusive practices, federal banking agencies may pursue any one of several informal actions or voluntary agreements. These include verbal or written commitments by bank officials to resolve identified problems, board resolutions that record such commitments, and memoranda of understanding that reflect an agreement between a supervisory agency and a bank's directors. Because these actions represent voluntary agreements, they are generally used in cases where bank management can be expected to take the necessary corrective steps.

For more severe violations and unsafe or abusive practices, banking agencies can issue formal and legally enforceable actions. These actions encompass written agreements, cease and desist orders, and suspension, prohibition, or removal actions. Under provisions amended by Congress in 1989, these actions can be directed toward depository institutions or any "institution-affiliated party."⁴⁶ The term institution-affiliated party not only includes bank directors, officers, employees, and controlling shareholders, but it can also extend to bank consultants, joint venture

⁴⁵ Since prompt corrective action directives are discussed on pages 90–95, this section will focus on the basic framework for taking enforcement actions and will also cover enforcement actions issued for other reasons.

⁴⁶ The 1989 amendments were contained in Title IX of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, 12 U.S.C. §1818. The definition of "institution-affiliated party" is contained in 12 U.S.C. §1813(u).

partners, and independent contractors for a bank, such as attorneys, appraisers, or accountants. Federal agencies must publish and make available to the public any formal actions they pursue and any modifications or terminations of these actions.

Cease and desist orders can be issued when an agency has reasonable cause to believe a depository institution or any institution-affiliated party has engaged or is about to engage in an unsafe or unsound practice or is in violation of a law, rule, regulation, written condition, or written agreement.⁴⁷ A cease and desist order will direct the institution or named parties to stop engaging in the specific practices or violations. In addition, the order may require affirmative action to correct any resulting conditions. Such action can include making restitution for unjust gains or reckless behavior, restricting the institution's growth, disposing of any loans or assets related to the institution's problems, rescinding agreements or contracts, employing qualified management or personnel, and other steps the agency deems appropriate.

An agency may issue final or temporary cease and desist orders. A final order provides an opportunity for an administrative hearing before it becomes effective. In contrast, temporary orders take effect immediately. However, to issue a temporary order, an agency must further find that the violation or practice is likely to either cause insolvency, significantly dissipate assets or earnings, weaken the institution's condition, or threaten depositors. Temporary orders can also be issued when an institution's records are so incomplete or inaccurate that its financial condition cannot be assessed. Administrative hearings can be held while a temporary order remains effective, and both final and temporary orders can be appealed within the federal court system.

⁴⁷ 12 U.S.C. §1818(b), 1818(c).

Written agreements are formal contracts between an institution and its federal supervisory agency regarding the institution's operations.

Federal banking agencies may also remove or prohibit the participation of selected individuals in an institution's operations. To do so, the agencies must find violations of laws, regulations, or supervisory orders; unsafe or unsound practices; or breaches of fiduciary duty.⁴⁸ Such actions must involve loss or potential damage to the institution, possible harm to depositors, or financial gain or other benefit to the individual. Furthermore, the actions must reflect personal dishonesty or willful disregard for the institution's safety. Until removal proceedings are completed, the agencies may suspend individuals from participating in banking operations. The removal, suspension, and prohibition provisions further prevent individuals from associating with any other depository institution without written agency consent.

In addition to supervisory orders, federal banking agencies may assess civil money penalties for institutions or parties violating laws, regulations, or supervisory enforcement actions; engaging in unsafe or unsound practices; or breaching fiduciary duties. These penalties have an initial ceiling of \$5,000 per day, but they may escalate to \$25,000 a day for recklessly engaging in an unsafe or unsound practice. The higher penalty may also be imposed when a pattern of misconduct is apparent, the institution suffers more than a minimal loss, or the party derives pecuniary gains or other benefits from the violations or unsafe practices. A maximum penalty of \$1 million a day or one percent of a bank's assets, whichever is less, applies to violations or actions done knowingly and which knowingly or recklessly cause a substantial loss to the institution or substantial gain to the individual. Criminal penalties may be sought for violations of removal, prohibition, and suspension orders; intentional violations of the Bank Holding Company

⁴⁸ 12 U.S.C. §1818(e).

Act; and bank criminal offenses, such as bribery, embezzlement, or falsifying bank records.

A final group of enforcement steps includes the termination of deposit insurance, appointment of bank conservators, and divestment of activities. Termination of insurance and appointment of a conservator are actions that are used only in the most serious situations and after other supervisory alternatives are exhausted, while divestment of activities is an enforcement step that federal regulators may take under the Gramm-Leach-Bliley Act of 1999. To terminate an institution's insurance through a final order, the FDIC must find unsafe or unsound financial conditions or practices or a violation of any law, regulation, or supervisory order or agreement. After insurance termination, insured deposits, less any subsequent withdrawals, remain insured for a period of at least six months, but no more than two years.

The Comptroller of the Currency and most state banking agencies may appoint a conservator to take over a problem bank and prevent any further dissipation of its assets pending final resolution steps. The Comptroller may establish a conservatorship over a national bank for a variety of reasons, although in most cases the bank must either be unable to meet depositor demands or be about to deplete its capital with no reasonable hope of recovery. A conservator may engage in normal banking operations, subject to any conditions the Comptroller might impose.

In addition, a federal banking agency may, with the concurrence of the FDIC, appoint a conservator over a critically undercapitalized bank it supervises. A federal banking agency supervising a state bank or the FDIC may also appoint a conservator under certain circumstances to facilitate the prompt corrective action provisions or to prevent losses to the bank insurance fund.

Under the Gramm-Leach-Bliley Act of 1999, the Federal Reserve Board and the Comptroller of the Currency may order financial holding companies and national banks to divest or cease certain activities if they fall out of compliance with the act and fail

to correct the deficiencies. For example, if a depository institution in a financial holding company fails to meet the well-capitalized or well-managed standards of the act and this condition is not corrected within 180 days, the Federal Reserve may order the company to divest control of any subsidiary depository institution or cease engaging in financial activities authorized by the act. Similarly, if a national bank or any insured depository institution affiliate fails to meet such standards and make corrections within 180 days, the Comptroller of the Currency may order the bank to divest control of any financial subsidiary. Federal Reserve regulations extend comparable provisions to state member banks with financial subsidiaries.

FDIC assessments and policies

The deposit insurance system is funded by assessments against the deposits at insured banks. These assessments help cover the FDIC's operating expenses and deposit insurance losses, and any remaining amounts go toward building up FDIC insurance fund reserves.

Because of declining insurance reserves, several large bank failures, and other banking problems in the 1980s, Congress established a new schedule in 1989 for FDIC insurance assessment rates. This schedule allowed for higher rates in order to strengthen the insurance fund and, over time, bring it up to a Congressionally mandated level of 1.25 percent of estimated insured deposits, which was reached in 1995. The Federal Deposit Insurance Corporation Improvement Act of 1991 further required the FDIC to establish a risk-based deposit insurance assessment system. Under this system, rates are to be linked to the probability that the insurance fund would incur a loss from a particular bank.

In its risk-based assessment system, the FDIC puts individual institutions into one of nine risk categories, based on an institution's placement into one of three capital subgroups and one of three supervisory subgroups. The three capital subgroups corre-

spond to whether an institution is well capitalized, adequately capitalized, or undercapitalized according to the current capital standards. The three supervisory subgroups are based on an institution's last examination rating, other relevant supervisory and financial information, and emerging risk characteristics.⁴⁹ To be in the top supervisory subgroup, an institution's condition generally must correspond to a composite examination rating of '1' or '2'. The next subgroup corresponds to '3'-rated institutions, while the last group primarily consists of '4'- and '5'-rated institutions.

Since 1996, FDIC assessment rates have ranged from 0 percent for banks in the top capital and supervisory subgroups to .27 percent of total assessable deposits for banks in both the bottom capital and supervisory subgroups. Banks with 97 percent of the deposit assessment base qualified for the 0 percent insurance premium for the second half of 2000, while less than 0.1 percent of all banks (8 banks) were paying the highest rate (.27 percent). At year-end 1999, the bank insurance fund had a \$29.4 billion balance, which left a reserve ratio of 1.36 percent of insured deposits.

Under its insurance powers, the FDIC has responsibility for the insured depositors at failed banks. The FDIC can protect these depositors either by paying off deposits or arranging for them to be transferred to or assumed by another bank. In addition, the FDIC can take a number of other steps to protect depositors and

⁴⁹ The FDIC assigns banks to supervisory subgroups based on a number of different factors. The FDIC uses a statistical model to predict a current composite examination rating for each bank based on its most recent financial data and the estimated relationship derived from previous examination ratings and corresponding financial information. Before a bank is placed in a supervisory subgroup, this predicted rating is then compared to other information on the bank, including the results of its last examination and any additional supervisory or financial information. In addition, the FDIC has added another step to this process to identify banks in the top supervisory category that might more appropriately be placed in a lower category due to certain emerging risk characteristics and concerns about their risk-management practices. The FDIC identifies such banks through supplemental screens, which look at rapid bank growth rates, concentrations of high risk assets, high-yield and high-risk loans, and rapid changes in business mix, and through conversations with the primary supervisor about a bank's risk-management practices.

resolve troubled banks, including bridge banks and FDIC financial assistance.⁵⁰

In choosing which of these options to use, the FDIC is required to use the method that will result in the least cost to the insurance fund. Moreover, the FDIC is specifically prohibited from taking any steps to protect uninsured depositors if such actions would increase losses to the insurance fund. The only exception to these least cost provisions is in emergency situations where compliance with the provisions “would have serious adverse effects on economic conditions or financial stability.”⁵¹ Such exceptions would have to be approved by two-thirds of the FDIC Board, two-thirds of the Federal Reserve Board, and the Secretary of the Treasury (in consultation with the President).

In a deposit payoff at a failed bank, the FDIC makes direct payments on all insured deposits, currently up to \$100,000 per depositor. In a deposit transfer, another bank takes over the insured deposits of the failed bank. In both deposit payoffs and transfers, depositors with uninsured accounts are given a claim on the receivership. They will receive proceeds from the FDIC’s liquidation of the bank on a proportionate basis after administrative expenses of the receiver and secured claims on the bank have been covered, but before foreign deposit claims and the obligations of other creditors are satisfied.⁵²

⁵⁰ The FDIC’s authority with respect to failing banks is largely derived from 12 U.S.C. §1821.

Failing banks are closed by their chartering authority — the Comptroller of the Currency for national banks and the appropriate state banking department or agency for state banks. Because of its insurance role and resources, the FDIC must be appointed as receiver for national banks and nearly always is appointed receiver for state banks by the state banking authorities. If necessary to reduce losses to the deposit insurance fund, the FDIC also may appoint itself as conservator or receiver for an insured bank after consultation with the appropriate state and federal agencies.

⁵¹ 12 U.S.C. §1823(c)(4)(G).

⁵² Subordinated debtholders and stockholders would not receive any proceeds from liquidation except when funds still remained after the general creditors had been fully reimbursed.

Other provisions could also affect stockholder interests at failing banks. Since 1989, depository institutions that are affiliated with an insured institution in default or receiving FDIC assistance may be required to reimburse the FDIC for any related costs.

In a deposit assumption, the failed bank is acquired by another party or merged with another institution. The acquiring group takes all or a portion of the failed bank's assets along with all of its deposits, both insured and uninsured. A purchase and assumption transaction consequently protects all depositors and maintains existing customer relationships. Because of these benefits, the FDIC attempts to use purchase and assumption transactions whenever they do not result in added costs for the insurance fund.

For a bank in default or in danger of default, the FDIC also may choose to reorganize its operations within a "bridge bank" to be chartered by the Comptroller of the Currency.⁵³ The primary purpose of a bridge bank is to give the FDIC time to arrange a successful sale or merger of a closed or failing bank. Bridge banks must either be less costly to the FDIC than a liquidation, essential for providing adequate community banking services, or in the best interest of depositors. A bridge bank is managed by a board of directors appointed by the FDIC, and it may take over any assets or deposits from its predecessor that the FDIC deems appropriate. Bridge banks exercise the same corporate powers held by national banks. However, their operations must be terminated through sale or closure within two years, unless the FDIC extends their status for up to three more years.

The FDIC may provide financial assistance to banks in order to prevent their failure, reopen closed banks, or lessen the FDIC's risk during unstable financial conditions.⁵⁴ The FDIC may also assist organizations that are acquiring or merging with these banks. This assistance can involve the FDIC making loans to or placing deposits in a bank, purchasing its assets or securities, assuming liabilities, or making contributions. For an acquiring organization, the FDIC may provide assistance through loans, contributions,

⁵³ 12 U.S.C. §1821(n). Similarly, a new national bank can be chartered under 12 U.S.C. §1821(m) to take over the insured deposits of a bank in default.

⁵⁴ 12 U.S.C. §1823(c).

deposits, security or asset purchases, deposit assumptions, or guarantees against loss. This assistance is at the sole discretion of the FDIC and must entail the least cost to the insurance fund of all possible approaches.

Annual independent audits and related reporting requirements

In addition to oversight by supervisory agencies, many banks also must be audited annually by independent public accountants. Section 112 of the Federal Deposit Insurance Corporation Improvement Act of 1991, as implemented, requires insured depository institutions with total assets exceeding \$500 million to submit audited annual reports to the FDIC and to the appropriate state and federal regulatory agencies.⁵⁵ This audit requirement is intended to help banks identify problems at an early stage and to bring about more stringent internal controls and more accurate reporting.

These annual reports must be made available for public inspection and must contain three items. One item is an audited annual financial statement and the independent public accountant's report on this statement. A second item is a report and assessment by bank management on the effectiveness of the bank's internal controls and its procedures for complying with safety and soundness regulations. The final item is the public accountant's report evaluating the bank's internal control structure and the assertions made by management. The financial statements must reflect generally accepted accounting principles. A consolidated bank holding company statement may be substituted for those of its subsidiary banks under certain circumstances.

The 1991 legislation also requires that each insured bank establish an audit committee comprised of outside directors who are

⁵⁵ 12 U.S.C. §1831(m), 12 CFR 363.

Many states also have their own set of internal and external audit requirements for state banks.

independent of the bank's management. The duties of this committee include reviewing the annual reports with bank management and the independent public accountant. For institutions with over \$3 billion in assets, at least two individuals on the audit committee must have banking or related financial management expertise, and the committee must have access to its own legal counsel.

SUMMARY

A variety of laws, regulations, and supervisory practices have evolved to protect depositors and limit the exposure of the deposit insurance system. With deposit insurance, most depositors are fully protected in the event that a bank should fail. Consequently, bank failures need not mean losses for depositors or economic disruption in a community or region. At the same time, though, banking problems and the risk exposure of the banking industry must be controlled if deposit insurance is to be a viable system and public confidence is to be maintained in banking.

The current regulatory and supervisory framework involves prohibitions and restrictions on some activities that could invite abusive or excessively risky actions. It also includes close supervisory oversight of key aspects of a bank's operations and policy making functions. These regulatory provisions and supervisory steps are supported as well by a wide range of enforcement powers for the banking agencies. Finally, state and federal banking agencies have a number of options for dealing with troubled and failed banks. These options allow the agencies to choose a solution most consistent with depositor protection concerns, financial stability issues, and deposit insurance costs.

This supervisory system is necessarily becoming more complex over time as banks take on additional activities and risks and as the financial system develops along many new and innovative paths. Over the past decade, for example, supervisory changes have included risk-based capital requirements, prompt corrective action

enforcement steps, early closure of failing banks, risk-based deposit insurance premiums, and risk-focused examinations. These changes represent an effort to protect depositors while controlling the cost and risk exposure in the federal deposit insurance system. In many cases, they also represent an effort to reduce the burden of regulation for soundly operated banks, while directing more supervisory attention to the banks most likely to encounter trouble. In addition, recent regulatory changes have sought to increase the role of market discipline in the safe and sound operation of banks. Further changes in regulation will be inevitable as banks pursue new activities and as legislators and regulators grapple with the question of what level of oversight will protect depositors adequately without needlessly restricting banks or threatening deposit insurance.

CHAPTER 6

Regulation Consistent with an Efficient and Competitive Financial System

In addition to their responsibilities for depositor protection and monetary stability, bank regulatory agencies are responsible for promoting an efficient, competitive banking environment and preventing monopolization of individual banking markets. This competitive objective received little attention in the aftermath of the Great Depression, when most regulatory attention was focused on protecting depositors and restoring the banking system. Today, however, the performance and competitiveness of the banking industry is viewed as a critical element in fostering a healthy and dynamic economy. Furthermore, as banks compete more directly with nonbank institutions and as new financial instruments and markets are created, many questions are being raised about what parts of the financial industry require close supervision and how this oversight can be implemented without stifling innovation or burdening the regulated institutions.

The traditional focus of competitive analysis has been the application of antitrust laws to bank expansion. Organizations generally must have prior approval of the appropriate regulatory agencies before expanding their banking operations through mergers or acquisitions, and this expansion must comply with antitrust standards. Bank regulators also have the authority to prevent director and management interlocks where a position of ownership has not been established. These antitrust actions, however, represent only one dimension of the competitive picture in banking. Competition and efficiency in banking, for instance, are affected by many other factors, including chartering policies, branching laws, limi-

tations on the scope of activities banks can undertake, and the overall cost of complying with other banking regulations.

Ironically, some restrictions originally adopted to promote safe and sound banking can adversely affect banking competition. Chartering and branching restrictions, for example, were implemented to ensure sound banks and stable banking markets, but these provisions can inhibit entry and thereby reduce competitive pressures on existing institutions. Similarly, restrictions on permissible banking activities, while undertaken to control bank risk taking and limit conflicts of interest, can reduce the competitive interplay in financial markets. In addition, such restrictions could leave banks less able to pursue profitable opportunities and adapt to ongoing trends in the financial marketplace. Consequently, a major task for bank regulators and bankers is to create a system of regulation that permits active competition in financial markets, while also protecting depositors and maintaining monetary stability.

This chapter addresses policies and regulations affecting banking competition and efficiency. Banking competition is reviewed first in terms of entry or chartering regulations, ownership regulations, branching and expansion regulations on a domestic and international level, and general antitrust considerations. The final portion of the chapter then looks at ongoing changes in the competitive environment and how such changes are affecting banks.

CHARTERING REGULATIONS

Since the inception of banking in this country, banks have nearly always been required to obtain a charter to conduct business. Bank chartering was adopted primarily to keep dishonest or inexperienced people or those with inadequate resources from operating banks and to prevent “over-banking” — either of which could lead to bank failures and possible depositor losses. By influencing the number of banks in a local market and the ability of others to enter, however, chartering requirements can also affect

competition and efficiency in banking. Generally, the more restrictive the chartering requirements, the harder it is for new banks to enter a market and the lower the competitive pressure on existing banks. As a result, restrictive chartering policies could serve to protect inefficient banks when more efficient and capable bankers are willing to enter.

Because of these diverse effects, chartering requirements and administrative policies toward chartering have fluctuated, depending on the weight given bank failure concerns relative to competitive considerations. Moreover, since a bank can be chartered by state authorities or by the Comptroller of the Currency, attitudes toward chartering policies may differ across agencies. These chartering options have further left bankers free to choose the charter and the supervisory authority under which they wish to operate.

National charters

The main function of the Office of the Comptroller of the Currency is the regulation and supervision of the national banking system. The Comptroller is unique among federal banking agencies in that it is the only one empowered to charter banks.

Requirements for establishing a national bank are outlined in the National Bank Act, as amended.¹ These include capital structure, articles of association, organizational certificate, and director, officer, and ownership requirements.

In addition to satisfying these requirements, national bank applicants must undergo a review or investigation by the Comptroller's staff. Much of this evaluation focuses on the organizing group's plan for operating the bank. This plan should show that the bank has reasonable prospects for achieving and maintaining

¹ 12 U.S.C. §§21-76. For more information on national bank chartering policies and procedures, see Office of the Comptroller of the Currency, "Charters," *The Comptroller's Corporate Manual*, Washington, DC, April 1998.

profitability, as demonstrated by projected bank balance sheets and income statements.

Other factors the Comptroller evaluates are the familiarity of the organizers with national banking laws and regulations, overall ability of the bank's proposed management, and likelihood that the bank will be operated in a safe and sound manner. To assist in these evaluations, the Comptroller requires proposed insiders to submit biographical and financial reports and then conducts background checks to assess each person's competence, experience, integrity, and financial ability. The Comptroller further considers whether the bank has the initial capital to support the expected volume of business and inherent operating risks. An organizing group must also submit a Community Reinvestment Act (CRA) statement. This statement should show how the bank proposes to meet the credit needs of its entire community, including low- and moderate-income neighborhoods.

Until 1980, the Comptroller of the Currency also gave much consideration to economic and competitive conditions in the community to be served. Since then, this emphasis has shifted from the economic effects a new bank might have on the market — for example, the effects on other banks or the ability of the market to support the new bank — to the capital resources and caliber of the bank's organizing group. This change reflects a belief that qualified individuals with a well-conceived operating plan can achieve profitability even in highly competitive markets or in markets with poor economic prospects. The policy change has thus helped to lower entry barriers and lessen any protection poorly run banks might once have had from new entrants and increased competition.

Two other important aspects of opening a national bank are Federal Reserve membership and federal deposit insurance. Upon receiving a charter, a national bank automatically becomes a member of the Federal Reserve and must comply with the regulations

applying to member banks, requirements for purchasing Reserve Bank stock, and Reserve Bank director election procedures.

Deposit insurance was once automatically given with a national bank charter. However, the Federal Deposit Insurance Corporation Improvement Act of 1991 now gives the FDIC responsibility for reviewing deposit insurance applications from both national and state banks. In reviewing a national bank's insurance application, the FDIC must consider seven factors:

- Financial history and condition of the bank (for banks already in existence)
- Adequacy of the bank's capital structure
- Earnings prospects of the bank
- General character and fitness of the bank's management
- Risk the institution presents to the bank insurance fund
- Convenience and needs of the community to be served
- Consistency of the institution's corporate powers with the purposes of the Federal Deposit Insurance Act²

The FDIC may conduct examinations or investigations in order to assess these factors and decide whether to grant insurance. As much as possible, the FDIC attempts to coordinate its information requests and investigations with that of the Comptroller's chartering procedures.

State charters

State bank chartering provides an alternative to opening a national bank. Chartering requirements, such as minimum capital levels, ownership and management structure, and application steps and standards, vary from state to state. In general, state

² 12 U.S.C. §1816.

authorities review many of the same basic factors as the Comptroller does in national bank chartering decisions.

One common element in this chartering process is the importance of FDIC insurance. Very few banks can attract small retail deposits without this insurance, and nearly every state requires state-chartered banks to obtain FDIC insurance before they begin operations.³ As a result, new state banks almost always file applications with the FDIC for deposit insurance and thus are reviewed at both the state and federal levels.

A state bank's need for deposit insurance consequently gives the FDIC veto power over virtually all state chartering decisions. Recognition of this power is expressed in the following FDIC policy statement: "The granting of deposit insurance confers a valuable status on an applicant; its denial, on the other hand, may have serious adverse competitive consequences, and in the case of a new bank, may effectively preclude entrance into the banking business."⁴

In evaluating insurance applications by state banks, the FDIC must analyze each request in relation to the same seven insurance factors listed for national banks. For newly organized banks, the FDIC Board of Directors gives special attention to capital adequacy and the quality of bank management.

State banks may also choose to become members of the Federal Reserve System. For membership applications by state banks, the Federal Reserve Act specifies several factors to be considered. These are "the financial condition of the applying bank, the general character of its management, and whether or not the corporate powers exercised are consistent with the purposes of this Act."⁵

The state chartering authorities, the FDIC, and the Federal

³ In addition, the Federal Deposit Insurance Corporation Improvement Act of 1991 requires banks that do not have federal deposit insurance to disclose that fact to their depositors and to obtain written acknowledgments from them.

⁴ Federal Deposit Insurance Corporation, "Statement of Policy Regarding Applications for Deposit Insurance," *Federal Register* 57, No. 71, April 13, 1992, 12822.

⁵ 12 U.S.C. §322.

Reserve carry out such examinations and investigations as they consider necessary to develop information and protect against unwarranted risk to the public or the banking system. Once a charter is granted and business is started, a new state bank must begin complying with state banking laws and regulations. In the event the bank obtains FDIC insurance or Federal Reserve membership, it must also commit to abide by the applicable regulations of these agencies, even if they are more stringent than state law.

BANK OWNERSHIP REGULATIONS

A key reason bank ownership is of interest to banking regulators is because stockholders provide the financial support behind a bank. In addition, bank ownership changes can affect competition and public benefits. Through ownership or management relationships, for instance, an individual or group could control more than one bank in a market. While such expansion in a market could be used to create a more efficient and competitive banking organization, it could also be used to develop a monopolistic position in the market and thus decrease the overall level of competition. Consequently, federal legislation has given the banking agencies authority to examine both the financial and competitive issues associated with bank ownership and control.

Bank ownership by individuals

The Change in Bank Control Act, a provision of the Financial Institutions Regulatory and Interest Rate Control Act of 1978, states that no individual or group acting in concert can acquire control of an insured depository institution without giving 60 days prior notification to the primary federal supervisor.⁶ Under the act, control means owning 25 percent or more of the voting shares of

⁶ 12 U.S.C. §1817(j).

the institution or having the power to direct its management or policies. In addition, an individual or group that will hold 10 percent or more of an institution's voting stock must file a change in control notice if the institution has issued registered securities or has no stockholders with greater holdings.⁷ In changes of control involving state banks, the federal agencies must also solicit the views of the appropriate state banking agency.

Information the acquiring party must report to a federal banking agency includes personal history, business background and experience, and financial data. Also required is information regarding the terms of the transaction, including the source of funds to finance the control change. The acquiring party must further discuss plans to sell, merge, liquidate, or change the structure or management of the bank. Other requested information includes a list of people hired to help in the acquisition, along with the terms of their employment. A copy of all offers to purchase stock must be provided. In addition to reporting this information, a person filing a change in control notice must publish an announcement of the change in a local newspaper.

The Change in Bank Control Act outlines the following grounds for disapproving a proposed acquisition:

- Creation of a monopoly, monopolization of any part of the banking industry, substantial lessening of competition, or restraint of trade
- Inability of public interest considerations to outweigh anticompetitive effects

⁷ The federal banking agencies generally do not require prior notification for additional purchases of stock, provided one has previously received clearance to make a purchase of 25 percent or more. Similarly, regulatory clearance to purchase more than a 10 percent interest would allow additional purchases to be completed up to a 25 percent ownership stake, unless otherwise noted.

- Potential for the financial condition of the acquiring party to jeopardize the bank's financial stability or adversely affect the interests of depositors
- Competence, experience, or integrity of proposed ownership or management is such that the change in control would not be in the public interest or in the interest of the bank's depositors
- Unwillingness of the acquirer to provide requested information to the federal banking agency acting on the ownership change petition
- The proposed transaction would adversely affect the bank insurance fund or the savings association insurance fund

Although the act is intended to ensure the safe, sound operation of banks, it also prevents ownership transfers where these conditions are satisfied but antitrust standards are breached. This act is a rarity among laws in that it subjects purchases by individuals to regulatory review for possible antitrust effects.

Bank ownership through corporations

The Bank Holding Company Act of 1956 — Corporate (bank holding company) ownership of banking institutions is regulated through the Bank Holding Company Act of 1956, as amended.⁸ Until this act, bank holding companies had been subject to little regulation. They could engage in nonbanking activities, and, in many cases, they could buy banks in more than one state. With the act, however, multibank holding companies were brought

⁸ 12 U.S.C. §1841 et seq, as implemented through Federal Reserve Regulation Y (12 CFR 225).

under the regulation and supervision of the Federal Reserve System, their nonbanking activities were restricted, and interstate banking was prohibited except in states passing enabling legislation. The act defined a bank holding company as any company that owned or controlled two or more banks. Companies owning a single bank were not included in the 1956 legislation and therefore were not yet subject to regulatory review.

As a consequence, the one-bank holding company became a means for many large banking organizations to expand into nonbanking activities in the late 1960s. To confine this expansion to activities closely related to banking, Congress amended the Bank Holding Company Act in 1970. These amendments set new standards for nonbanking activities and redefined company to include the ownership or control of a single bank. One-bank holding companies thus came under the same regulatory framework as multibank companies.

Several subsequent changes to the act have also been of critical importance. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 changed the act's interstate banking provisions to allow banking organizations to acquire banks in any state. The Gramm-Leach-Bliley Act of 1999 then authorized a wider range of financial activities and affiliations for a new type of bank holding company to be known as a financial holding company. Both of these legislative acts thus liberalize key provisions and objectives of the original Bank Holding Company Act.

Regulation of holding companies — Bank holding company transactions that require approval or notification of the Federal Reserve System include formations and mergers of bank holding companies, acquisitions of banks, and proposals to engage in nonbank activities. In reviewing these transactions, the Federal Reserve must consider a variety of factors relating to financial and competitive considerations and public benefits, meaning the convenience and needs of the community to be served.

The Federal Reserve cannot approve the formation of a bank

holding company or a company's proposal to acquire a bank if it believes financial and managerial resources and future prospects of the company and bank are unsatisfactory.⁹ Nor can it approve a proposal that would lessen competition substantially or cause resources to be concentrated in any section of the country unless public benefits outweigh any anticompetitive effects. Public benefits thus become a balancing factor which can override other concerns and lead to approval of a transaction.¹⁰

In holding company applications involving national banks, the Federal Reserve Board must notify and seek the views and recommendations of the Comptroller of the Currency. Similar opportunities must be provided to the appropriate state supervisor in applications involving state banks.

Bank holding companies may engage in nonbanking activities under a number of different conditions. The most common of these has been for activities the Federal Reserve Board has determined to be closely related to banking. For traditional bank holding companies, the Gramm-Leach-Bliley Act of 1999 limits this group of activities to those that the Federal Reserve had approved by regulation or through an order prior to November 12, 1999 (See Table 8). Before engaging in these activities, a holding company must file a notice with the Federal Reserve and show that the public benefits of engaging in the activity, such as greater convenience, increased competition, or gains in efficiency, outweigh any possible adverse effects. These adverse effects might include an undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices. Expedited approval procedures are available for well-capitalized holding com-

⁹ The Riegle Community Development and Regulatory Improvement Act of 1994 allows a holding company to just give prior notice to the Board in cases involving a simple reorganization of bank ownership interests into a holding company structure.

¹⁰ The specific language of the competitive standard is the same as that for bank mergers, which is presented on page 167. Also, for more information on the bank holding companies and bank acquisitions that would be subject to these acquisition standards, see pages 41–46.

Table 8
List of Permissible Nonbanking Activities
for Traditional Bank Holding Companies

1. Extending credit and servicing loans
2. Activities related to extending credit, including real estate appraisals, arranging commercial real estate equity financing, check-guaranty services, collection agency services, and credit bureau services
3. Leasing of personal or real property if the lease is on a nonoperating basis, the initial term of the lease is at least 90 days, and, in the case of real property leasing, will yield a return that compensates the lessor for the full investment in the property and the estimated total cost of financing the property over the term of the lease
4. Operating nonbank depository institutions, including industrial banks and savings associations
5. Trust company functions
6. Financial and investment advisory activities
7. Agency transactional services for customer investments, such as securities brokerage, riskless principal transactions, private placement services, and futures commission merchant
8. Investment transactions as principal, including underwriting and dealing in government obligations and selected money market instruments, certain investing and trading activities, and buying and selling bullion
9. Management consulting and counseling activities — primarily on financial or economic matters or for financial organizations
10. Support services, such as check printing and courier services for certain financial instruments and financially related data
11. Insurance agency and underwriting activities, including provision of credit-related insurance for customers of the holding company or its subsidiaries and insurance agency activities in small towns or by holding companies with total assets of \$50 million or less
12. Community development activities
13. Issuance and sale of money orders and traveler's checks and sale of U.S. savings bonds
14. Data processing — primarily of a financial, banking, or economic nature

Plus any activity that the Federal Reserve Board had determined by an order prior to November 12, 1999, "to be so closely related to banking as to be a proper incident thereto."

Note: For a more detailed description of these activities, see Federal Reserve Regulation Y (12 CFR 225.28).

panies that are predominantly made up of well-capitalized and well-managed institutions. The Bank Holding Company Act allows holding companies to engage in nonbanking activities through a number of other exemptions. For instance, holding companies can make passive investments (less than a five percent ownership stake) in any company.

The final group of permissible nonbanking activities is for bank holding companies that have elected to become financial holding companies under the Gramm-Leach-Bliley Act of 1999. To become a financial holding company, an organization must file a written declaration with the Federal Reserve Board and certify that the depository institutions it controls are all well capitalized and well managed.¹¹ All of these institutions must also have at least satisfactory ratings on their most recent CRA examinations.

Financial holding companies are authorized to operate under a broader range of affiliations and nonbanking activities than traditional bank holding companies are. As shown in Table 9, financial holding companies may engage in activities that are financial in nature, including securities underwriting and dealing, insurance agency and underwriting activities, and merchant banking. Furthermore, companies that are already engaged in such activities may become financial holding companies themselves and acquire banks.

To engage in financial activities that are specifically authorized in the Gramm-Leach-Bliley Act, an organization must notify the Federal Reserve Board within 30 days after commencing the activity or acquiring a company engaged in the activity. A written request must be submitted for activities that have not yet been determined to be financial in nature or incidental to a financial activity. Activities complementary to a financial activity require prior approval from the Federal Reserve Board. Financial holding companies and their depository institution affiliates must continue to meet the well-capitalized and well-managed standards or face

¹¹ For more on financial holding companies, see pages 46–49 of this book.

Table 9
Permissible Activities for
Financial Holding Companies

1. Any activity that the Board had determined by regulation or order prior to November 12, 1999, to be closely related to banking
2. Activities that are usual in connection with the transaction of banking abroad
3. Any activity that the Federal Reserve Board, in consultation with the Secretary of the Treasury, determines “to be financial in nature or incidental to such financial activity” or “is complementary to a financial activity and does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally”

The Gramm-Leach-Bliley Act specifically considers the following activities to be financial in nature:

- A. Lending, exchanging, transferring, investing for others, or safeguarding money or securities
- B. Insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death; or providing and issuing annuities; and acting as principal, agent, or broker for purposes of the foregoing
- C. Providing financial, investment, or economic advisory services, including advising an investment company
- D. Issuing or selling instruments representing interests in pools of assets permissible for a bank to hold directly
- E. Underwriting, dealing in, or making a market in securities
- F. Activities corresponding to Item 1 above
- G. Activities corresponding to Item 2 above
- H. Acquiring an ownership interest in a company to be held for a period of time to enable the sale or disposition of the company as part of a bona fide merchant banking or underwriting activity, provided the shares are held by a securities affiliate or an insurance underwriting affiliate and registered investment adviser
- I. Acquiring an ownership interest in a company when this interest represents an investment made in the ordinary course of business in accordance with state law, provided the shares are held by an insurance company predominantly engaged in underwriting activities (other than credit-related insurance) or providing or issuing annuities

Note: For a more detailed description of these activities, see 12 U.S.C. §1843(k) and Federal Reserve Regulation Y (12 CFR 225.86).

corrective supervisory action and possible termination of the financial activities or divestiture of their banking operations. Also, the failure to maintain CRA ratings would keep an organization from taking on new financial activities.

This expanded list of permissible activities for financial holding companies thus will allow organizations to respond more fully to their customers' financial needs, while increasing competition in many of these areas. In addition, entry by other types of financial firms into banking will likely bring a new source of ideas and approaches to banking.

Regulation of management interlocks

Unlike the regulations that limit ownership, regulations governing management interlocks relate to the positions individuals hold in depository institutions and their parent holding companies. Where ownership regulations discourage anticompetitive acquisitions, interlock regulations limit an individual's ability to simultaneously hold positions at institutions not under common ownership. The intent of interlock restrictions is to keep individuals from taking management positions at competing institutions in order to reduce the existing competition and to circumvent possible antitrust restrictions on direct ownership.

Originally, management interlocks were governed by section 8 of the Clayton Act. However, the Depository Institution Management Interlocks Act, which was part of the Financial Institutions Regulatory and Interest Rate Control Act of 1978, now provides the framework for regulating management interlocks, along with a number of subsequent amendments.¹² An institution's primary federal regulator enforces the act and issues the implementing regulations.

The management interlock provisions apply to individuals serv-

¹² 12 U.S.C. §§3201-3208, as implemented by 12 CFR 26 for national banks and affiliates; 12 CFR 212 (Regulation L) for state member banks, bank holding companies, and affiliates; and 12 CFR 348 for insured state nonmember banks and affiliates.

ing as “management officials” at unaffiliated depository institutions. A management official can be anyone acting as a director or as an employee or officer in a managerial position at a depository institution. Also included are de facto management officials, such as advisory directors or honorary directors, and anyone who has a representative or nominee serving in a management capacity.¹³ All depository institutions — banks, thrifts, industrial banks, and credit unions — are covered by the interlock provisions. Under the act, two depository institutions or organizations are generally considered to be unaffiliated if there is no common group of stockholders having more than a 25 percent interest in both entities.

The act contains three specific instances where management interlocks are prohibited, and these provisions are aimed at institutions that are most likely to compete with each other either because of their close proximity to one another or their substantial size. First, a management official of an institution or organization may not serve in a similar capacity at an unaffiliated institution or organization if both have offices in the same community (community prohibition).¹⁴ Beyond this community prohibition, a management official may not serve at two unaffiliated institutions or organizations if they have offices in the same metropolitan area and both organizations have total assets of \$20 million or more (metropolitan or RMSA prohibition).¹⁵ This provision thus prohibits interlocks across larger, metropolitan areas, unless one of the institutions is too small to offer significant competition.

The third interlock prohibition (major assets prohibition) applies to large depository institutions or organizations, regardless

¹³ The interlock prohibitions of the act, however, do not apply to advisory or honorary directors at depository institutions with less than \$100 million in total assets.

¹⁴ A “community” refers to a city, town, or village and any contiguous or adjacent cities, towns, or villages.

¹⁵ The act employs the “relevant metropolitan statistical area” or RMSA terminology of the Office of Management and Budget in establishing metropolitan areas. An RMSA is either a primary metropolitan statistical area (PMSA), a metropolitan statistical area (MSA), or a consolidated metropolitan statistical area (CMSA) that is not comprised of designated PMSAs.

of their location. A management official of a depository institution or holding company that has total assets of more than \$2.5 billion cannot hold a management position at any unaffiliated depository organization with assets of more than \$1.5 billion.¹⁶

The act and its regulations exempt several types of interlocks from these prohibitions on the grounds that competition is unlikely to be harmed in such situations. For instance, interlocks are permissible if the unaffiliated organizations together hold less than 20 percent of the deposits in each community or RMSA where they both have offices and the organizations are not large enough for the “major assets” interlock prohibition to apply. In addition, the act specifies that the federal banking agencies may grant exemptions for interlocks that “would not result in a monopoly or substantial lessening of competition.” Under this authority, the agencies may allow interlocks for limited periods of time if the institution seeking management help primarily serves low- and moderate-income areas, is controlled or managed by minorities or women, has been chartered less than two years, or is in troubled condition. Other exemptions include institutions in receivership, failed or failing institutions for up to a five-year period after they are acquired by another organization, and certain interlocks grandfathered at the time the 1978 legislation became effective.

GEOGRAPHIC SCOPE OF OPERATIONS

Banking competition and efficiency are also influenced by the avenues that banks and bank holding companies have for expanding their operations geographically. Such avenues include additional branch offices, bank holding company acquisitions of banks and nonbanking firms, mergers with other institutions, and electronic or internet banking. Depending on state and federal laws, a

¹⁶ The banking agencies may adjust, as necessary, these asset sizes to allow for inflation or market changes.

banking organization might use these or other forms of expansion to extend its operations within a particular state, across state lines, or even into foreign countries.

Regulation of bank expansion opportunities has generated much controversy. By giving banks an opportunity to enter new markets and attract additional customers, liberal expansion policies can promote greater competition. Such policies also enable banks to compete more directly with other types of institutions and to offer a broader range of services as their customer base becomes larger. At the same time, however, some people fear that expansion by larger institutions could further concentrate banking industry resources and risks and create financial monopolies. Also, some are concerned that multi-office expansion could produce very large organizations that might have little interest in the needs of local communities and, in the event of problems, might pose a serious threat to financial stability.

Because policies on the location of banking activities have traditionally been set by the states, regulations relating to where banks can locate and expand have varied markedly from one state to another. These differences, though, have declined over the years as a result of many states liberalizing laws with regard to bank branching, multibank holding company expansion, and foreign bank entry. Federal interstate banking and branching laws passed in 1994 have also eliminated many differences, although federal statutes still defer to state laws in other areas.

Expansion within a state

Branching — Bank branching within a state is largely a matter of state discretion. Under the McFadden Act of 1927, as amended in 1933, national banks may only branch to the same extent as state banks within a state.¹⁷ State laws therefore establish branch-

¹⁷ 12 U.S.C. §36.

ing powers for both state and national banks. Although states may also set the range of activities to be conducted from a branch, almost all states now give branches broad authority, allowing them to conduct full service banking operations.

State restrictions on branches and facilities have become more relaxed over the years, and with these changes, the number of banking offices has grown. The liberalization of branching laws follows improvements in communications, computerization, and transportation, all of which contribute to the feasibility of multi-office banking. Another factor leading some states to relax branching restrictions was the banking problems of the 1980s and the consequent need to encourage acquisitions of problem and failed institutions.

Several states have also changed their branching laws because of a 1985 branch approval decision by the Comptroller of the Currency. This decision, as upheld in court, allowed a national bank to branch according to the more liberal standards a state had authorized for state-chartered thrift institutions.¹⁸ After several similar OCC branch approvals in other states, a number of states passed laws or used “wildcard” statutes to give state banks equal branching authority.

Forty-four states plus the District of Columbia allow bank branching on an unlimited statewide basis. Minnesota, New York, and South Dakota each allow banks to establish branches on a statewide basis except in smaller communities already served by local banks. On the other hand, Iowa, Kentucky, and Nebraska only allow a bank to open new branches within the metropolitan area or county where it is located. Nebraska, however, allows statewide branching by merger, since a bank may acquire other financial institutions from anywhere within the state and then

¹⁸ The Comptroller ruled that the state had given thrifts much the same powers as state banks and these thrifts could therefore be regarded as state banks for purposes of the McFadden Act (*Mississippi Department of Banking and Commerce v. Clarke, Comptroller of the Currency*, 809 F.2d 266 (5th Cir. 1987), *cert. denied* 107 S.Ct. 3240 (1987)).

convert their offices into branches. This branching framework thus indicates that very few states still impose restrictions on a bank's ability to expand through branches — a rather sharp departure from several decades ago when the majority of states either prohibited branching or put tight geographic limits on it.

State banks must receive approval from their state banking department to open a branch office. A state bank also must have approval of the Federal Reserve System if it is a member bank, or from the FDIC if it is an insured nonmember bank. Consequently, the branching proposals of state banks are reviewed at the federal level as well.

The Comptroller of the Currency evaluates branch applications by national banks. Since national banks face the same branching restrictions as state banks, the Comptroller is bound by any state limitations on branch locations, number of branches, and capital requirements. The McFadden Act, though, contains its own definition of "branch." As originally written, the act defined a national bank as any additional office "at which deposits are received, or checks paid, or money lent." This definition has been more encompassing compared to some state laws, which have often had separate and more abbreviated approval procedures for automated teller machines. Much of this difference was eliminated in 1996 when automated teller machines and remote service units were specifically excluded from the definition of national bank branches.

Banks must not only have regulatory approval when opening branches, but they must also notify bank regulators and the customers of a branch before it can be closed. Such notification is intended to protect customers and communities from the loss of banking services and to provide time to find other banking alternatives.

Insured banks, for example, must comply with federal statutes when closing branches. Under federal law adopted in 1991, a bank must notify its primary federal supervisor at least 90 days before a proposed branch closing. This notice must further include a detailed statement of the reasons for closing the branch plus the

statistical or other information supporting these reasons. The regular customers of a branch must also be given 90-days written notice of its closing, and a notice of the closing is to be posted at the branch at least 30 days before the planned closing. These prior notice procedures, though, are not required for closing automated teller machines or, in most instances, for relocating or consolidating branches within the same neighborhood. A final federal requirement is that banks with branches adopt written policies for branch closings, addressing such factors as criteria for closing branches and procedures for notifying customers.

In addition, a number of states have instituted special branch closing requirements for state-chartered banks. These provisions typically call for notification of customers and the state banking authority prior to branch closures.

Bank holding company expansion — The Bank Holding Company Act defers to the states on the limits placed on intrastate holding company acquisitions of banks. All states allow multibank holding companies, but many of the states impose some form of restrictions on holding company acquisitions of banks within the state. Among the most common restrictions are deposit caps, which prohibit holding companies from acquiring more than a fixed portion of statewide deposits. On the interstate level, the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 allows holding companies to acquire banks in any state and to convert these acquisitions into branches. State deposit caps, if in effect, apply to interstate acquisitions as well, and many states prohibit out-of-state companies from acquiring banks that are less than five years old.

Historically, bank holding company acquisitions have been of particular importance in interstate expansion and in states that have had restrictive branch banking laws. Until interstate branching became possible a few years ago, holding companies offered the only means for interstate expansion. Also, in states that have limited branching within their borders, multibank holding com-

panies have offered a way to build banking networks similar to those in states without branching restrictions.

Apart from bank acquisitions, holding companies can also expand their operations by engaging in permissible nonbanking and financial activities on an intrastate or interstate level. These activities allow holding companies to offer a variety of financial services in both local and more distant markets.

Bank mergers — Bank mergers provide another means for banking organizations to expand their operations. Such mergers are regulated at the federal level by the Bank Merger Act of 1960, as amended. Bank mergers must also satisfy any relevant state laws and approval procedures. In particular, if multiple bank offices are to be maintained after a merger, such offices must be consistent with state merger and branching laws in those states that still have branching restrictions.

The Bank Merger Act was passed to clarify the antitrust policies applying to bank mergers. Prior to the act, many people questioned whether U.S. antitrust laws applied to banking since banks were already regulated extensively and little bank antitrust prosecution had occurred. In the 1940s and 1950s, the Justice Department and the Federal Reserve Board tried to apply provisions of the Sherman and Clayton Acts to a few banking agreements and acquisitions. Legal difficulties in these cases, along with a congressional sentiment to place bank acquisitions under the control of federal banking agencies, then led to the Bank Merger Act.

The Bank Merger Act of 1960 and its 1966 amendments require a bank to obtain prior approval before merging, consolidating with, or acquiring assets and assuming liabilities of another bank. The federal banking agency reviewing the merger request is the agency that would supervise the resulting bank. In this review, an agency must consider the financial and managerial resources and future prospects of the existing and proposed institutions. In addition, the 1966 amendments impose a single competitive standard for banking agencies, the Department of Justice, and the

courts to follow in assessing the legality of mergers. Under this standard, agencies cannot approve:

(A) any proposed merger transaction which would result in a monopoly, or which would be in furtherance of any combination or conspiracy to monopolize or to attempt to monopolize the business of banking in any part of the United States, or

(B) any other proposed merger transaction whose effect in any section of the country may be substantially to lessen competition, or to tend to create a monopoly, or which in any other manner would be in restraint of trade, unless it finds that the anticompetitive effects of the proposed transaction are clearly outweighed in the public interest by the probable effect of the transaction in meeting the convenience and needs of the community to be served.¹⁹

The agency handling a merger application also must ask the other two federal banking agencies and the U.S. attorney general to report their views on the competitive effects of the proposal.²⁰ Overall, these merger approval standards and procedures are intended to help ensure that mergers are only approved if they are in the public interest.

Department of Justice review — Once a merger proposal or a bank acquisition by a holding company is approved by a federal banking agency, the Justice Department has 30 days to complete its own review of the competitive effects and decide whether to challenge the proposed transaction.²¹ To reduce the uncertainty of a possible antitrust suit, the Justice Department has published

¹⁹ 12 U.S.C. §1828(c). In July 1966, section 3(c) of the Bank Holding Company Act (12 U.S.C. §1842(c)) was amended to include the same standards for acquisitions, mergers, and consolidations subject to that section.

²⁰ Under provisions adopted in 1994, the other federal banking agencies need not file a formal report on a merger if the merger does not raise any competitive issues. These agencies must still notify the agency with jurisdiction over the merger of this conclusion.

²¹ With the concurrence of the U.S. attorney general, this period can be reduced to as few as 15 days on mergers and holding company acquisitions that will not be receiving an adverse comment (See section 321 of the Riegle Community Development and Regulatory Improvement Act of 1994).

guidelines indicating the kind of mergers or acquisitions most likely to be challenged.²² The guidelines try to take into account the number and size of the firms competing with the merging banks. Competing firms are generally considered to include other banks in the market. In addition, this competitive analysis may recognize other financial institutions, particularly if these institutions have powers similar to banks and are making inroads into banking markets.

For purposes of merger analysis, competing firms usually are identified by the delineation of a geographic market area. These market areas, which are specified for all offices of the merging banks, contain those firms that either compete directly or would be affected by a change in competitive terms, such as a change in the price or quality of service at one of the firms.

The guidelines try to gauge the extent of competition in a market through use of the Herfindahl-Hirschman Index (HHI). In calculating an HHI, each competitor's market share of a certain product, such as bank deposits, must be determined. The market share for each of these firms is then squared and the sum of all these numbers represents the HHI for the market. Thus, the HHI reflects both the number of firms in a market and their relative size.²³ If other significant factors are equal, markets with high HHIs are judged to be less competitive than those with low HHIs. This is because a high HHI implies a market dominated by a few large firms.

On the basis of its HHI, a market is considered by the Justice Department to be unconcentrated, moderately concentrated, or highly concentrated. The higher the market concentration, the

²² U.S. Department of Justice and Federal Trade Commission, "Horizontal Merger Guidelines," *Federal Register* 57, no. 176, September 10, 1992, 41552-41563; and "Justice Department and Federal Trade Commission Announce Revisions to Merger Guidelines," Press Release, U.S. Department of Justice, April 8, 1997.

²³ As an example, a market with five firms having individual market shares of 30, 20, 20, 20, and 10 percent would have an HHI of 2200 ($30^2 + 20^2 + 20^2 + 20^2 + 10^2 = 2200$).

more likely the Justice Department is to challenge a proposal and the smaller a merger or acquisition must be to avoid an antitrust suit. This policy is summarized in Table 10.

For large mergers in highly concentrated markets, the Department of Justice, as well as the federal banking agencies, must then examine the specific factors unique to each merger and the likely effect on competition. In its 1992 guidelines, the Justice Department elaborated on some of the more important factors that would be considered in its merger reviews. These factors, as they relate to banking, include: (1) the major products or services offered by the merging banks and the level of market competition and concentration in each product line, (2) the likely ability of the merged bank and other market participants to act in a noncompetitive manner, (3) the prospects for entry by organizations outside the market or expansion by other market participants, (4) possible efficiency gains from the merger, and (5) extenuating circumstances, such as the imminent failure of one of the merging banks and the lack of alternative solutions. Mergers raising competitive issues can thus be expected to undergo a more intensive review, and the merging banks will likely face a greater burden of proof in demonstrating public benefits.

Electronic banking — Electronic banking has created another means for banks to expand the scope of their operations, and the volume and variety of electronic banking services have risen dramatically in recent years. Such services now include automated teller machines (ATMs) and ATM networks, debit cards, merchant point-of-sale (POS) terminals, telephone banking, home or office banking terminals, internet banking and bank websites, automated clearinghouse (ACH) transactions, check and credit verification systems, wire transfers, smart cards, and other electronic payments. Overall, these developments have made banking transactions quicker, more convenient, and cheaper. In addition, electronic banking is allowing banks to reach an almost unlimited

Table 10
Merger Guidelines of the
U.S. Department of Justice*

	Unconcentrated market	Moderately concentrated market		Highly concentrated market		
Post-merger HHI	Below 1000	1000 to 1800		Above 1800		
Increase in HHI due to the merger	Any increase	Less than 100	More than 100	Less than 50	50 to 100	More than 100
Probability of Justice Department challenging merger	Unlikely	Unlikely	More likely than not	Unlikely	Depends on post-merger HHI, increase in HHI due to merger, and other factors	Likely

* These are general guidelines the Justice Department applies to all types of mergers. In 1985, the Department of Justice announced that it would apply more lenient guidelines to most bank mergers because of increasing competition from thrift and nondepository institutions and the imprecise nature of geographic market boundaries in banking. Under these guidelines, the Justice Department has stated that it generally would not challenge a bank merger unless the post-merger HHI was at least 1800 and the increase in the HHI due to the merger was at least 200. For a statement of this policy, see: Charles F. Rule, Acting Assistant Attorney General, letter to C. Todd Conover, Comptroller of the Currency; "Report on the Competitive Effects of the Acquisition by Bank of Jackson, Jackson, Mississippi, of Brookhaven Bank and Trust Company, Brookhaven, Mississippi," February 8, 1985.

In several subsequent bank merger cases, though, the Department of Justice has pursued an alternative approach of directly analyzing the strength of nonbank competition and then applying the general merger guidelines when deemed appropriate (see the Department of Justice letter on the acquisition by First Hawaiian, Inc., Honolulu, Hawaii, of First Interstate Bank of Hawaii, Inc., Honolulu, Hawaii, October 5, 1990, p. 19, footnote 24).

group of customers, while opening banking and the financial services field to a wide range of new competitors.²⁴

One of the first steps in electronic banking was the development of ATMs. Although ATMs were first introduced in 1970, their use did not become widespread until the late 1970s. Their growth has continued with the development of less expensive, but more reliable machines; an increase in customer acceptance of electronic facilities; and the creation of ATM networks that give bank customers access to terminals operated by other institutions. Another factor in ATM growth has been the spread of surcharging

²⁴ Issues regarding electronic fund transfers and consumer protection are reviewed on pages 215–219.

on ATM transactions. Surcharges, which are fees that a bank's customers pay to use an ATM owned by another institution, had been prohibited by the major ATM networks until 1996. The two largest ATM networks dropped their bans on surcharging in that year and were followed by nearly all of the regional networks. The revenue from surcharges has provided a strong incentive for many banks and other ATM providers to install additional terminals, particularly in high-traffic, off-premise locations. The total number of ATMs in the United States has increased from about 60,000 terminals in 1985 to more than 285,000 terminals in May 2000.

Although a few states still treat ATMs much the same as bank branches for regulatory purposes, the vast majority of states, as well as the OCC, have simplified application or notification requirements for installing ATMs. These simplified requirements are based on the fact that ATMs mostly offer routine transaction services and involve much less of an investment compared to branches.

The legal and regulatory framework is also important in many other aspects of ATM operations. For instance, state laws commonly address such issues as where institutions can place ATMs within the state and on an interstate basis, the authority of nonbank institutions to operate ATMs, the services that can be dispensed from ATMs, state limits on surcharges and other fees, policies on sharing and access to other institutions' ATMs, and rules regarding the operation of ATM networks within a state. Although it is not easy to summarize state ATM laws, most states have given institutions fairly broad authority to establish ATMs on a statewide and interstate basis and have granted other states reciprocal entry rights. Most states have also allowed nonbank institutions to operate ATMs but, in some cases, have restricted the services they can offer. All but a few states allow surcharges by ATM operators, and under federal law, these fees must be disclosed to consumers.

States have taken a number of different approaches in their policies on institutions sharing their ATMs with other institutions.

Sharing of terminals has become a very important factor in ATM usage, and the vast majority of ATMs are now shared among bank and nonbank institutions, most commonly through network agreements. ATM networks allow customers to access their funds beyond an institution's own facilities and, in many cases, on a national and worldwide basis. Sharing has also helped institutions achieve the high volume of transactions needed for efficiently operating ATM terminals. ATM networks have been organized by bank and nonbank institutions, and these networks have set their own operating standards and agreements regarding the requirements to become a member, access and network linkages between institutions, interchange fees, and other policies. The spread and mergers of ATM networks across the country have further increased the importance and influence of the networks and their sharing agreements.

Because network sharing agreements can create access and competitive issues, federal antitrust policies have tended to favor the development of competing networks that offer equal access for all institutions.²⁵ For similar reasons, some states have imposed mandatory or nondiscriminatory sharing laws that give all institutions equal access to ATMs within the state. These laws typically require institutions to grant other institutions access to their ATMs at a fair and equitable cost. Many other states, though, have not imposed mandatory sharing in the belief that the market should be free to determine how ATMs are used and that individual institutions should have full control over their own ATMs.

A more recent electronic banking development that is attracting much industry and regulatory interest is internet banking and the use of bank websites. Banking over the Internet can occur under three basic forms. Some banks have websites that are used

²⁵ In a 1994 case pursued by the Justice Department, the nation's largest regional ATM network settled charges of monopolistic practices by agreeing to price its access fees on a nondiscriminatory basis and to allow its users to connect with competing ATM networks (*United States of America v. Electronic Payment Services Inc.*, Civ. No. 94-208, D.C. Del., 4/21/94).

primarily to provide information about the bank and its services to both existing and potential customers. Other banks have more complex websites that serve as remote delivery and transactional channels for such services as opening new accounts, transferring funds among accounts, presenting and paying bills electronically, writing other checks, and applying for loans. A third and rarer option is the “virtual” bank that has no traditional banking offices for customers to visit, but instead provides all of its services over the Internet and through the use of other institutions’ ATMs.

Internet banking is growing rapidly, and many institutions continue to increase the type and complexity of services that they offer through their websites. FDIC statistics suggest that approximately 4,100 banks and thrifts had websites as of June 30, 2000, and about 1,350 of these offered some type of transactional services. This represented a doubling of websites from two years before and a more than fivefold increase in transactional sites. An OCC study also showed that more than 54 percent of national banks had websites by the third quarter of 1999, with 21.5 percent of all national banks offering transactional websites.²⁶

From a regulatory perspective, internet banking raises many of the same concerns as other banking activities, plus several unique issues. In their reviews of electronic banking operations, commercial bank examiners and information technology specialists first look at such traditional considerations as board of directors’ oversight of the activity and the use of appropriate policies and procedures, internal controls, and risk management practices. However, examiners must also assess a bank’s handling of the unique security issues related to doing business over the Internet and its oversight of third-party providers and vendors of electronic banking platforms. Other areas to evaluate include a bank’s monitoring of elec-

²⁶ Karen Furst, William W. Lang, and Daniel E. Nolle, “Who Offers Internet Banking?,” *Quarterly Journal*, vol.19, Office of the Comptroller of the Currency, June 2000.

tronic transactions and the technical skills of bank personnel in setting up electronic banking services and dealing with problems.

Other unique regulatory issues in internet banking include a bank's ability to "know its customers" in a faceless environment, legal and risk considerations in lending or providing other services to customers in distant locations, fluctuations in business activity that could occur from being connected to a much wider and more volatile customer base, and a customer's ability to distinguish a bank's website from other sites with which it may be linked. Another issue, the validity of digital signatures, led to the Electronic Signatures in Global and National Commerce Act of 2000, which makes electronic signatures as legally binding as written signatures in nearly all circumstances.²⁷ In addition to these considerations, bank websites must further be in compliance with any applicable consumer protection statutes and regulations. Consumer protection laws that could come into play include consumer disclosure requirements, equal credit opportunity provisions, privacy policies, electronic fund transfer protections and responsibilities, and community reinvestment objectives.

Over time, these electronic banking developments will continue to produce significant changes in our financial system. Such developments promise to greatly alter the competitive environment in banking by removing the operational and geographic barriers that have prevented individual institutions from reaching out to a wider range of customers. Also, electronic banking and new types of competitors on the Internet could alter much of the cost and price structure in banking, while turning customers away from banks with expensive office networks. Other notable changes are likely to include customer bill paying practices, the cost of banking transactions and services, and the variety of financial services and institutions available to customers. For regulators, electronic banking could also lead to many changes as institutions gain

²⁷ Public Law 106-229, 15 USC §§7001-7006, 7021, 7031.

the ability to rapidly alter their customer base and balance sheets and as many longstanding geographic constraints disappear with regard to where banks and their customers can conduct business.

Interstate banking

Many banking organizations are now pursuing expansion on an interstate level. The incentives for interstate banking are coming from the rapid evolution in payments and communications systems, profitable opportunities in new markets, and a need for greater risk diversification. Other important factors are the rising number of bank customers with interstate operations and increasing competitive pressure from less regulated institutions. In addition, liberalization of the legal framework for interstate expansion is giving banking organizations greater freedom to respond to these incentives.

Historically, banking organizations have faced a variety of constraints in their interstate expansion, and they have had to pick from a limited set of interstate options. Among these have been grandfathered banking activities by bank holding companies, state laws allowing out-of-state banking organizations to enter, state laws allowing banks to establish branches in another state, limited-service banks and nonbank banks, acquisition of failing or problem institutions, and interstate nonbanking activities of bank holding companies.²⁸ Much of this legal framework for interstate banking, though, has been largely supplanted by the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. This act allows banking organizations to acquire banks in any state and to consolidate their operations through interstate branching. As a result, banking organizations now face few regulatory barriers to interstate expansion.

²⁸ For more information on these interstate banking provisions and their prior use, see the previous edition of this book: Kenneth Spong, *Banking Regulation: Its Purposes, Implementation, and Effects* (4th Edition, Federal Reserve Bank of Kansas City, 1994), pp. 149-158.

Provisions of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 — The Riegle-Neal Interstate Banking and Branching Efficiency Act was passed by Congress to establish a consistent nationwide standard for interstate expansion by banking organizations. It replaced 50 state entry laws that had taken many different approaches to interstate banking under the sanction of the Douglas Amendment to the Bank Holding Company Act. Since September 29, 1995, this federal legislation has allowed bank holding companies to acquire banks in any state.

The act sets a number of requirements for regulatory approval of interstate bank acquisitions. These requirements relate to the capital and managerial adequacy of the acquiring company, its Community Reinvestment Act (CRA) record, and any minimum bank age requirements up to five years that a state might impose on interstate acquisitions. For instance, bank holding companies making interstate bank acquisitions must be adequately capitalized and adequately managed, and the Federal Reserve Board must take a company's CRA record into consideration to the same extent as it would with any other bank acquisition. The act allows states to set minimum bank age requirements for interstate acquisitions in the interest of limiting the disruptive effects that interstate entry might have on the existing state banking structure. Approximately half of the states require a bank within their borders to have been in operation for at least five years before it can be acquired on an interstate basis. Over one-third of the states have no age requirement, thus allowing holding companies to enter these states by chartering new banks. The remaining states typically have three-year minimum age requirements. In addition, any interstate bank acquisition by a bank holding company must meet the same Federal Reserve application and approval requirements as any other bank acquisition, including financial and managerial considera-

tions, future prospects, convenience and needs of the community, and antitrust standards.²⁹

Interstate bank acquisitions must also comply with concentration limits on the maximum share of deposits an organization can acquire within a state and on a nationwide basis. For instance, an interstate organization cannot make additional acquisitions in a state if it would control 30 percent or more of the total deposits in insured depository institutions in that state. A state, however, may override this provision in either direction with an alternative deposit cap, provided this cap does not discriminate against interstate entrants. About two-thirds of the states have chosen not to adopt their own deposit cap or have officially adopted the same 30 percent deposit cap specified in the legislation. The remainder of the states have adopted a different deposit cap, and in most cases, this cap is less than 30 percent. The nationwide concentration limit is 10 percent of the total deposits in all insured depository institutions in the United States. The act allows adequately capitalized and managed companies to acquire failing or FDIC-assisted banks without meeting the deposit cap standards, a state's minimum bank age requirements, or community reinvestment criteria.

Since June 1, 1997, mergers have also been permissible between banks located in different states, thus allowing interstate holding companies to consolidate their existing banks into a single branch network and to acquire other banks as branches through interstate merger transactions. Banks resulting from interstate merger transactions retain all of the same branching rights previously held by the merged banks. The 1994 legislation gives states the right to opt out of these interstate branching provisions or to adopt an earlier starting date. Only two states, Texas and Montana, decided to opt out

²⁹ In addition to these interstate acquisition provisions, the Riegle-Neal Act allows the bank subsidiaries in a holding company to act as agents for any affiliated depository institutions in performing such banking tasks as receiving deposits, renewing time deposits, closing loans, servicing loans, and receiving loan payments. As a result, affiliated institutions can operate as if they were branches of one another instead of separate entities.

initially, but both set a sunset date for their legislation, after which interstate branching can occur. About half of the states adopted earlier starting dates for interstate branching than specified in the legislation. Apart from interstate mergers of existing banks, states may also elect to authorize interstate branching on a *de novo* basis, and about one-third of the states have taken this step.³⁰

Interstate merger transactions must satisfy the same concentration limits as interstate acquisitions. They must also comply with CRA requirements and any state laws on minimum age of the acquired bank. In addition, the merging banks must be adequately capitalized when the merger application is filed, and the surviving bank is expected to be adequately capitalized and adequately managed when the merger takes place. These requirements could be waived for mergers involving one or more failing or FDIC-assisted banks.

Under the 1994 legislation, application procedures for interstate bank acquisitions and mergers generally conform to that of other acquisitions and mergers. Holding companies must apply to the Federal Reserve Board for prior approval of any interstate bank acquisitions. Interstate bank merger and branching proposals are reviewed by the federal agency having supervisory responsibility over the resulting bank. State banking agencies also evaluate such requests from state banks.

Furthermore, interstate mergers involving state or national banks must comply with the filing requirements of any host state where the resulting bank will have interstate branches, provided the requirements do not discriminate against out-of-state organizations. The laws of the host state regarding community reinvestment, consumer protection, fair lending, and the establishment of intrastate branches apply to interstate branches as well.³¹ In order

³⁰ The interstate banking acquisition provisions, section 101 of the Riegle-Neal Act, primarily amend section 3(d) of the Bank Holding Company Act (12 U.S.C. §1842(d)). The interstate merger provisions, section 102 of the Riegle-Neal Act, amend the Federal Deposit Insurance Act by adding a new section at the end (12 U.S.C. §1831u).

³¹ An exception to these laws may be made for national bank branches when federal law preempts the application of state law to national banks or the Comptroller of the Currency determines that such laws would discriminate against national banks.

to close an interstate branch, a bank must follow relevant state and federal laws, which include allowing its federal supervisor to collect public comments on any interstate branch closings in low- to moderate-income areas.

Overall, the interstate banking and branching provisions of the Riegle-Neal Act are increasing interstate entry and expansion opportunities in many states. These provisions have eliminated a variety of restrictions that states had previously placed in their interstate entry laws, including regional acquisition limits, reciprocal entry requirements between states, and prohibitions on interstate branching. As a result, interstate entry can proceed on a more efficient basis, and regional and nationwide organizations can give their customers expanded access to banking services. This interstate legislation also allows banking organizations to achieve greater geographic diversification and brings additional competition into many banking markets. As long as interstate expansion occurs in a manner that continues the flow of services to local banking markets and limits the concentration of banking resources and risks, this easing of interstate barriers will help maintain an efficient and competitive financial system.

International banking

International banking has expanded rapidly in the past few decades in response to rising international trade, the rapid development of the Eurodollar market and many international financial centers, and significant improvements in international communications. Greater cooperation among countries has also been an important factor as shown by the North American Free Trade Agreement and the European Union and its adoption of the Euro. In this expansion, banks have shown a strong preference for countries of major importance in international finance and trade, as well as those with favorable regulatory climates and tax systems.

Because of the large number of banks that have expanded into

other countries, international banking has become a highly competitive business, with narrow profit margins on many transactions. An additional factor facilitating international banking has been the development of international clearing and financial telecommunication systems. Two of the most important are SWIFT, a telecommunications network linking many of the largest banks and financial firms throughout the world, and CHIPS, an electronic money-transfer network serving large institutions with New York offices, such as major New York banks, Edge corporations, and New York offices of foreign banks.

International expansion by U.S. banks — In addition to conducting international business from its domestic office, a U.S. bank or bank holding company can follow other avenues in offering its international services. These include foreign branches, Edge corporations, foreign subsidiary banks, international banking facilities, and export trading companies.³² Each of these approaches is subject to certain regulations of state and federal authorities. Expansion abroad is also subject to the laws and regulations of the host country. Some countries allow foreign banks to conduct a wide variety of activities and operate in much the same manner as banks based in that country. On the other hand, a few countries prohibit or severely restrict any kind of foreign bank entry. A number of other countries permit entry only through branches or may otherwise limit the activities foreign banks can conduct.

Foreign branches have been a common way for U.S. banks to enter foreign markets. As additional offices of U.S. banks, foreign branches are directly supported by a U.S. bank's capital and financial and managerial resources. At the end of 1998, 82 U.S. banks

³² Many of the rules regarding the foreign activities of U.S. banking organizations, as well as the U.S. activities of foreign banking organizations, are contained in Federal Reserve Regulation K (12 CFR 211).

were operating a total of 935 foreign branches with \$705 billion in total assets.³³

To open a foreign branch, a U.S. bank must comply with all applicable laws both in the United States and in the foreign country and must receive regulatory approval from the appropriate banking agencies. For state banks, the authority to branch abroad and the range of permissible activities for a branch depend on state law. A foreign branch application by a state bank is scrutinized by its state banking agency. In addition, an insured state nonmember bank must obtain written consent from the FDIC before opening foreign branches, unless the bank already has a branch or subsidiary in that country. State member banks must seek branching permission from the Federal Reserve System, which also processes all foreign branch requests by national banks.

For member banks that already have branches in as many as two countries, the Federal Reserve System requires 45 days prior written notice for branching into an additional country. Unless an organization has been notified otherwise, no prior Federal Reserve approval is required for additional branches in a country where a bank already has a branch. Other foreign branching requests by member banks require prior approval of the Federal Reserve Board.

Ongoing supervision of foreign branches is the responsibility of the primary supervisory authority. However, the Federal Reserve is empowered to order special examinations of the foreign operations of national banks.

In general, state and federal laws in this country allow the foreign branches of U.S. banks to offer a full line of banking services, although foreign laws may limit these services. A member bank can also apply to the Federal Reserve for permission to engage in other activities through a foreign branch if the activities are commonly conducted by banks in the foreign country. Foreign

³³ For more information on international banking activities and their growth, see James V. Houpt, "International Activities of U.S. Banks and in U.S. Banking Markets," 85 *Federal Reserve Bulletin* 599 (September 1999).

branches of state nonmember banks can engage in activities approved by the FDIC, provided the activities have been authorized by the state as well.

Edge corporations provide another means to engage in international banking.³⁴ Edge corporation powers are generally limited to international banking services and certain incidental activities. Edges cannot accept deposits from U.S. residents or businesses unless the deposits are directly linked to international trade. In addition, Edge corporations may make foreign investments of a banking or financial nature. Typically, organizations have conducted international banking activities and foreign investment activities through separate Edge corporations, thus creating two types of Edges — banking Edges and investment Edges.

To form an Edge corporation, investors must have approval from the Federal Reserve System and must satisfy statutory capital requirements and a number of basic organizational steps. The Federal Reserve also evaluates financial, managerial, competitive, and convenience and needs factors in acting on Edge proposals. Supervision and examination of Edge corporations are the responsibility of the Federal Reserve System.

Edge corporation ownership is open to two groups. First, an investor group, corporation, or company can apply to own an Edge, provided the majority of the shares or the controlling interest will be held by U.S. citizens. Second, foreign banks, foreign institutions owning foreign banks, and U.S. banks controlled by foreign banking organizations can establish and own Edges subject to any conditions the Federal Reserve may impose. Companies forming or acquiring Edge corporations after 1987 must also comply with the provisions of the Bank Holding Company Act, including the restrictions on nonbanking activities.

In addition to its head office in the United States, an Edge cor-

³⁴ Edge corporations are named after Senator Walter Edge of New Jersey, who sponsored the 1919 legislation that authorized these corporations.

poration can operate branches both in this country and abroad. Foreign branches of Edges fall under the same notification and approval procedures as member bank foreign branches. Edges can open domestic branches after giving 45 days notification and after Federal Reserve consideration of financial, managerial, competitive, and convenience and needs factors.

Banking organizations have used Edge corporations as a means of offering international banking services in New York, other major U.S. markets, and a number of foreign markets. Much of the early expansion in Edge corporations occurred when interstate banking restrictions limited other forms of entry across major markets in the United States. At year-end 1998, more than 30 banking Edges were in operation with \$18 billion in total assets.

Edge corporations, member banks, and bank holding companies can also invest directly in foreign banks and other organizations. Member banks are restricted to investments in foreign banks, while Edge corporations and holding companies may invest in foreign subsidiaries that conduct activities of a banking or financial nature, as well as other activities that are necessary to carry on such operations. The regulatory approval process for investments in foreign subsidiaries depends on the size and type of the activity and the capital of the investor. The Federal Reserve Board gives its general consent for investments that are small relative to the investor's size. Prior written notice must be given to the Board for larger investments, and specific Board consent is needed for activities not qualifying for the other procedures. State banks, both member and nonmember, must also comply with any state statutes on foreign investments. At the end of 1998, U.S. banking organizations operated a total of 1,133 foreign subsidiaries with over \$718 billion in assets. Because of the broader investment powers of Edge corporations, 70 percent of these assets were owned through Edges.

A further means of engaging in international banking is through international banking facilities (IBFs), which the Federal

Reserve first authorized on December 3, 1981.³⁵ IBFs were introduced as part of the continuing effort to make U.S. banks and their domestic offices more competitive at the international level. U.S. depository institutions, domestic offices of Edge corporations, and U.S. branches and agencies of foreign banks can establish IBFs. These facilities are free of reserve requirements and any local taxes that government bodies choose to waive. Only international transactions, involving either IBF time deposits or loans, are allowed at an IBF, and notification to the Federal Reserve is the only action required to begin operations. IBFs are not required to maintain separate facilities. They can be merely a set of asset and liability accounts segregated on the books and records of any depository institution, Edge corporation, or U.S. branch or agency of a foreign bank. At year-end 1998, the IBFs of U.S. banks had \$46 billion in assets, while the IBFs of U.S. branches and agencies of foreign banks had \$169 billion in assets.

Finally, as a result of the Bank Export Services Act, which was included in the Export Trading Company Act of 1982, bank holding companies and certain other banking organizations may invest in export trading companies. Export trading companies are organizations principally engaged in exporting or facilitating the export of goods or services produced in the United States. Banking organizations investing in export trading companies must give prior notice to the Federal Reserve Board.

Foreign bank entry into the United States — Many foreign banks have started or greatly expanded their operations in the United States over the past few decades. This entry can be attributed to the importance of the United States in the world economy, its relatively stable political and economic structure, and a continuing growth in international trade and finance. Depending on state and federal laws, foreign banks can choose from several

³⁵ The regulatory provisions governing IBF operations are contained in Federal Reserve Regulation D (12 CFR 204.8).

means of entry, including state or federal branches and agencies, Edge corporations, representative offices, and direct investment in U.S. banks. Branches of foreign banks generally can conduct a full range of banking operations, including accepting deposits on an international level and, in some instances, from U.S. residents. Agencies, on the other hand, either cannot accept deposits or, in a few cases, can hold foreign deposits or credit balances only. Edge corporations are limited to international banking services, while representative offices provide services for their parent bank, including soliciting new business, generating loans, and maintaining relations with correspondent banks and other customers. With a U.S. subsidiary bank, foreign ownership groups can engage in the same banking activities as other U.S. banks.

As of June 30, 2000, approximately 19 percent of U.S. banking assets were under foreign ownership. This figure includes 289 branches of foreign banks with \$883 billion in total assets, 72 agencies with \$37 billion in assets, and 89 U.S. banks with \$341 billion in assets controlled by foreign interests. Other foreign banking activities in the United States include 8 Edge corporations and 206 representative offices.

Foreign bank operations in the United States are governed by a combination of state and federal statutes, relating to licensing and application requirements, entry and expansion powers, safety and soundness considerations, and permissible activities. Foreign bank branches and agencies, for instance, can choose to operate under either a state or a federal license. One common element in this state and federal regulatory framework, though, is some form of federal oversight for virtually all foreign bank operations in the United States.

This federal oversight was strengthened by the Foreign Bank Supervision Enhancement Act of 1991, which was enacted as part of the Federal Deposit Insurance Corporation Improvement Act of 1991. Under this legislation, federal authority now extends to the prior review and approval of any form of foreign bank entry

into the United States. It also encompasses supervisory oversight of the resulting banking operations, restrictions on permissible activities, and termination of any activities when deemed necessary. This expanded authority was, in part, an outgrowth of the rapid increase in foreign bank operations in the United States. It also reflected several gaps in the federal oversight of foreign bank operations and two isolated instances of fraudulent banking activities by foreign organizations.

Under this federal regulatory framework, foreign banks seeking to establish a state branch, state agency, representative office, or commercial lending company must first fulfill the licensing requirements of the state and must also receive prior approval from the Federal Reserve Board. Although the resulting operations are primarily regulated by state law, federal statutes further require that the powers of state branches and agencies generally conform to the permissible activities for federal branches.

Federal branches and agencies must receive approval from both the Comptroller of the Currency and the Federal Reserve Board. Before approving an application for a new branch or agency, the Comptroller must consider the proposal's competitive effects, the convenience and needs of the community, and the financial and managerial resources and future prospects of the parent bank and the branch or agency. In reviewing applications for federal branches and agencies, as well as for any other foreign bank office in the United States, the Federal Reserve must assess financial and managerial factors and several other considerations. It must also determine that a foreign bank is either subject to comprehensive supervision or regulation on a consolidated basis in its home country or the home country authorities are actively working toward this objective. This latter provision is to help ensure that the home country supervisors are taking responsibility for the overall health and soundness of the foreign bank and its various activities.

Federal branches and agencies are subject to whatever regulations and asset requirements the Comptroller deems appropriate

and consistent with maintaining competitive equality with state branches and agencies. Federal agencies cannot receive deposits or exercise fiduciary powers. Depending on their operations, state and federal branches may be subject to reserve requirements, FDIC regulations on insurance of domestic deposits under \$100,000, and many of the consumer protection laws.

The authority to license state or federal branches and agencies has also been dependent on whether a particular state has granted such entry privileges. Many states have not allowed foreign bank branches or agencies, but most states with significant levels of international trade and financial activity have authorized at least one of these forms of entry. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, though, authorizes a foreign bank to establish and operate state and federal branches and agencies in any state outside of its home state, provided a state or national bank could branch under the same circumstances.³⁶ The establishment of representative offices, on the other hand, remains a matter of state law.

A foreign bank or foreign company acquiring a U.S. bank must comply with provisions of the Bank Holding Company Act and will need prior approval from the Federal Reserve before making the acquisition. In addition, the operations of a foreign-owned U.S. bank must conform to the same laws and regulations applying to any other U.S. bank of the same charter class.

Certain provisions of the Bank Holding Company Act, including the restrictions on nonbanking activities, also apply to any foreign bank or company which maintains branches, agencies, or commercial lending companies in the United States. Foreign banks, however, may receive an exemption from the nonbanking restrictions if the majority of their business is in banking and most of their banking operations are conducted outside of the United

³⁶ Section 104(a) of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (12 U.S.C. §3103(a)).

States. This exemption thus allows foreign banks to conduct any type of activity outside of the United States that their home country allows and to engage in U.S. activities that are incidental to their foreign business.

Foreign banks or companies may also elect to become financial holding companies and to thereby engage in the broad range of financial, incidental, and complementary activities made possible by the Gramm-Leach-Bliley Act of 1999. To become a financial holding company, a foreign bank and any U.S. depository institutions it controls must be well capitalized and well managed. In addition, these depository institutions and any U.S. branches of the foreign bank that have FDIC insurance must have at least satisfactory CRA records. Foreign banks are considered well capitalized and well managed if they meet standards comparable to those that U.S. organizations must meet.

The state banking departments and the Comptroller of the Currency supervise and examine any foreign banking operations that they have chartered or licensed. In addition, the Federal Reserve Board has authority to examine any U.S. branch, agency, commercial lending company, representative office, or subsidiary bank controlled by a foreign bank. Such examinations are to be coordinated with the other agencies whenever possible and duplicate examinations are to be avoided. Each branch or agency must be examined by an appropriate state or federal authority on the same frequency as a state or national bank would be examined.

Although supervision and examination of the U.S. operations of foreign banking organizations (FBOs) share many similarities with that of domestic institutions, a number of unique considerations are important. In particular, the soundness of these operations ultimately depends on the financial condition of each FBO and the level of support the organization can provide to its U.S. operations. As a result, U.S. supervisors assess not only the condition of all U.S. activities of an FBO, but also the FBO's ability to provide financial, liquidity, and management support to its U.S. operations.

Key factors that U.S. supervisors review in assessing an FBO's ability to support its U.S. operations are the FBO's overall financial condition and managerial strength, the level of supervision the FBO receives in its home country, the record of home country support of the banking system, and any transfer risk concerns. These factors are then used to derive a **Strength-of-Support Assessment (SOSA)** ranking. This ranking is on a scale from '1' to '3' with '1' corresponding to the lowest level of supervisory concern and the highest level of support for U.S. operations. SOSA rankings thus summarize the overall viability of the FBO, any inherent weaknesses, and the external constraints under which it operates. The rankings are further used by U.S. supervisors in developing a strategy for oversight of the FBO's operations in the United States.

The second step in FBO supervision is to assess the overall condition of an FBO's U.S. operations. U.S. banking agencies have a special risk-focused examination program that they apply to FBOs, especially those with multiple entities in this country operating under different supervisors. For each U.S. branch or agency of an FBO, the appropriate U.S. supervisors derive a ROCA rating (**R**isk management, **O**perational controls, **C**ompliance, and **A**sset quality). These ratings are then factored into a combined rating for all branches and agencies of the FBO.³⁷ The combined rating will, in turn, be incorporated with assessments of the FBO's other U.S. operations to construct an overall rating of U.S. activities.

State and federal bank regulators have a variety of enforcement powers they may use in supervising foreign bank activities in the United States, including authority at the federal level to levy civil money penalties. In addition, the chartering or licensing agency may order a foreign bank to terminate activities at a U.S. office for such reasons as violations of law, unsafe or unsound practices, or the initiation of resolution proceedings against a foreign bank by

³⁷ U.S. branches, agencies, and commercial lending companies receive a rating from '1' (strongest) to '5' (weakest) on each of the ROCA components, as well as a composite rating on the same scale.

its home country authorities. The Federal Reserve may take similar actions against state-licensed offices and may recommend such actions for federal branches and agencies.

Supervisory and regulatory considerations in international banking — In their evaluations of international lending activities and other banking operations, supervisors take many of the same steps as they do with domestic activities. For instance, supervisors generally look at the foreign activities of U.S. banks in terms of their effect on the overall risk and condition of the bank and the consolidated organization. However, several new considerations must also be applied to foreign activities.

Foreign lending risks are influenced by both a borrower's ability to repay (credit risk) and the risk inherent in extending funds in another country (country risk and transfer risk). In fact, loan repayments and investment returns in a specific country can be affected by a number of unique factors not commonly associated with domestic credits. Foreign loan repayments depend upon the foreign exchange available in a country, currency or exchange rate movements, or the existence of exchange controls. In extreme cases, repayment could be precluded by social, political, or economic turmoil or by such government actions as nationalization of industries, repudiation of debts, or expropriation of property. Supervisors commonly use "country risk" to refer to this entire spectrum of risks — economic, political, and social — that arises from doing business in another country. More specifically, supervisors use the term "transfer risk" to describe the possibility that a borrower might not be able to service a loan in the currency required for payment, either because of exchange controls, currency devaluations or depreciation, or other factors creating foreign exchange shortages.

Because of these added risks, U.S. and foreign bank supervisors closely review the international activities of their banks and examine each bank's international lending policies, internal controls, and credit exposures in every country where it has substantial

activities. Any significant credit exposures are analyzed according to a bank's ability to absorb and control the resulting risks through capital funds and managerial resources. Supervisors further consider the economic and financial condition of each foreign country where a bank has business, as well as that country's political and social stability. The condition of individual credit customers in each country is another important factor in assessing a bank's overall risk exposure.

To provide experience and consistency among U.S. supervisors, a committee of examiners from the federal bank regulatory agencies, the Interagency Country Exposure Review Committee (ICERC), formally reviews conditions in foreign countries and then assigns a transfer risk rating to exposures in each country. The ICERC also prepares country write-ups that summarize current conditions in a country and the specific reasons for its transfer risk rating. The transfer risk ratings and other country risk supervisory procedures are not intended to replace a bank's own country risk analysis and are not meant to channel credit to or from particular countries. In fact, because of the uncertainties in assessing country risk, foreign credit examination procedures primarily attempt to encourage banks to diversify across countries and avoid concentrations within a single country.

These supervisory procedures were further strengthened in response to international debt problems in developing countries during the 1980s. Such problems prompted Congress to solicit proposals from the banking agencies and subsequently pass the International Lending Supervision Act of 1983.³⁸ According to the act, the banking agencies are to consider foreign country exposure and transfer risk when evaluating a bank's capital adequacy. The act also directs the agencies to require banks to maintain special reserves when either the quality of their assets is impaired by the protracted

³⁸ 12 U.S.C. §§3901-3911, as implemented by 12 CFR 28, subpart C, for national banks; 12 CFR 347, subpart C for state nonmember banks; and 12 CFR 211, subpart D, for state member banks, Edge corporations, and bank holding companies.

inability of foreign borrowers to make debt payments or no definite prospects exist for the orderly restoration of debt service.

To implement these capital and special reserve provisions, the agencies have established three classification categories for credits adversely affected by transfer risk: substandard, value impaired, and loss; and these categories are used in the ICERC transfer risk ratings. A bank's exposure to a particular country is classified as substandard if the country is not complying with external debt service obligations and has not adopted a suitable economic adjustment program or negotiated a viable rescheduling of debt. Value impaired credits are loans to borrowers in a country with protracted arrearages, such as a failure to pay interest for six months or to meet rescheduling terms for more than a year. Loss credits are loans in countries that have repudiated their obligations to banks and other lenders or have economic conditions or payment records that make repayment unlikely. These loans are considered uncollectible and should no longer be carried as bankable assets.

In addition, another category, other transfer risk problems, was created for nonclassified credits warranting special attention. This category applies when a country is not meeting its external debt service obligations, but has taken steps to restore debt servicing. The category is also used for loans that have been regularly serviced, but an interruption in servicing is imminent, and for loans that have improved enough to no longer warrant classification in one of the other three categories.

In classifying a bank's exposure to a particular country into one of these categories, examiners first consider the ICERC transfer risk ratings. However, if the credit risk posed by a particular borrower warrants a more severe classification than would be called for under a country's transfer risk rating, then examiners are to classify the credit according to the borrower's risk. Furthermore, the ICERC transfer risk ratings do not apply to claims on local country residents that are funded by liabilities to local country residents.

All of the transfer risk categories are to be considered in evalu-

ating a bank's capital and reserves. For value impaired credits, banks must establish allocated transfer risk reserves or write down such assets. To assist banks in setting proper reserve levels, the ICERC recommends a specific percentage amount that should be reserved against each value-impaired country exposure. Allocated transfer risk reserves are then to be charged against current income and cannot be counted as part of a bank's total capital. The International Lending Supervision Act also calls for appropriate accounting of fees on international loans and mandates public disclosure, on at least a quarterly basis, of a bank's material foreign country exposure.

These international lending provisions were tightened in 1989. Congress, acting out of concern over the protracted failure of some countries to make debt payments, directed federal banking agencies to closely review country risk exposures and the adequacy of reserves at major U.S. banks. Under this 1989 legislation, the agencies are to provide direction on the level of reserves to be maintained by banks with medium- and long-term loans to highly indebted countries. In doing so, the agencies must give special attention to loans classified for two or more years as substandard or with other transfer risk problems.

Apart from country risk considerations, a number of other factors influence the examination and regulation of international banking activities. In examining foreign branches and subsidiaries of U.S. banking organizations, supervisory agencies tailor their examination procedures to the type of operation and the information available on the entity being reviewed. In many cases, the record of foreign branch or affiliate operations kept at the U.S. head office is complete enough for much of the examination. Head office examinations are especially useful for banks with strong audit and internal control systems, as well as in countries that have not encouraged the presence of U.S. regulatory personnel. In other cases, supervisors conduct on-site examinations, especially for significant activities. Additional factors influencing

examination procedures include the amount of information provided in regular supervisory reports, the degree of secrecy accorded to bank records in foreign countries, and the type of regulation and supervision imposed by foreign countries.

One other regulatory consideration is the growing interdependence of U.S. and foreign banks with extensive international networks. As these networks continue to expand, more cooperation among regulatory authorities in different countries is needed to accomplish mutual supervisory objectives, strengthen the international financial and supervisory systems, avoid jurisdictional disputes, and eliminate protective entry barriers in a number of countries. Expansion in international banking is also forcing the United States and other countries to reevaluate many of their regulatory policies. For example, differences in regulations, taxation, and legal frameworks are encouraging banks to shift activities to countries with the most favorable banking climate and, in some cases, least stringent supervisory systems.

In response to such shifts, many countries have relaxed some of their more restrictive regulations and pursued international cooperation in maintaining other regulations. These cooperative efforts have occurred among such groups as the Basel Committee on Banking Supervision at the Bank for International Settlements, the European Union, and the North American Free Trade Agreement (NAFTA) countries.

An initial step in international supervisory cooperation was a 1975 paper in which the Basel Committee on Banking Supervision obtained agreement of the G-10 Governors on principles for the supervision of foreign offices of international banks.³⁹ This agreement, which became known as the Basel Concordat, recognized that no foreign activities should escape supervision and that

³⁹ The Group of Ten originated from ten member countries of the IMF (Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom, and the United States). Switzerland, which was not then a member of the IMF, was also added to the group.

supervision of international banking organizations is the joint responsibility of the parent or home country supervisor and the authority where the foreign activities are conducted (host country supervisor). The Concordat also specified a division of supervisory responsibilities between parent and host countries, but these principles were more fully addressed in a new Concordat in 1983 and in a 1990 supplement to the agreement. Moreover, the Committee established a list of minimum standards in July 1992 for the supervision of international banking and then introduced core principles for effective supervision in September 1997.⁴⁰

All of these steps attempt to ensure that banking activities in different countries are supervised according to certain basic principles. One of the key principles spelled out in 1992 is “that international banks should be supervised by a home country authority that capably performs consolidated supervision.” This supervisory standard places overall responsibility on the home country supervisor for the safety and soundness of a banking organization’s consolidated operations. Consequently, home countries should prevent their banks from expanding into countries which do not have adequate supervision, and host countries are to assure themselves that an organization is adequately supervised in its home country before allowing it to expand across borders. In addition, supervision of foreign banking activities is to be a joint responsibility of host and home countries. Host countries have a basic duty to oversee any subsidiaries established by foreign banks in their country and to deal with liquidity issues in local markets, but home country authorities must be ready to fill any gaps in the supervisory process and to help supervise the foreign branch operations of their banks.

There are many other examples of international supervisory

⁴⁰ Bank for International Settlements, Basel Committee on Banking Supervision, “Minimum standards for the supervision of international banking groups and their cross-border establishments,” July 1992; and Bank for International Settlements, Basel Committee on Banking Supervision, “Core principles for effective banking supervision,” September 1997.

cooperation. One such effort is the risk-based capital guidelines developed through the Basel Committee in the late 1980s and subsequently adopted by more than 100 countries. Another example is the 1992 program to create a single integrated marketplace within the European Union. This program allows banks to obtain an operating license from any European country and then branch and offer a wide variety of financial services within any member country. A similar effort, NAFTA, liberalizes entry into financial services across North America under the concept of national treatment, in which foreign entrants are treated the same as their domestic counterparts. In addition, NAFTA allows citizens of Mexico, Canada, and the United States to purchase financial services from institutions in the other countries. The need for this type of international cooperation will continue to exist as international trade and financial transactions become more routine and as banking organizations throughout the world expand their foreign activities.

CHANGES IN THE COMPETITIVE MARKETPLACE

In past years, many bankers had viewed themselves as competing primarily with other bankers for customers, and they paid far less attention to other types of financial institutions. This view was in keeping with the traditional structure of the U.S. financial system, which had been characterized by specific types of institutions serving selected or specialized markets.

Banks, for example, had long been the only institutions allowed to offer transaction accounts and related services. Banks also focused on short-term business credit, but made most other types of loans as well. Savings banks and savings and loan associations developed as a means of meeting housing finance needs, while credit unions became a vehicle for serving part of the consumer savings and credit market. By marketing corporate debt and equity offerings to investors, securities firms took on the role of finding financing for longer-term business needs. Other parts of the finan-

cial system, including insurance companies and pension funds, also confined their operations to certain well-defined functions, which did not directly overlap with those of other financial institutions.

Under this traditional framework, consumers and businesses commonly dealt with one set of institutions for a particular need and went to other institutions for other financial needs. As a result, most competition was among institutions with the same type of charter, and competitive interplay between different types of institutions was limited by both custom and regulation.

Over the past few decades, this financial structure has changed significantly. Technological innovation, profit pressures, unmet customer needs, new financial instruments serving multiple purposes, and a changing regulatory framework have provided many market participants with the ability and the incentive to begin exploiting profitable opportunities in other sectors. Improvements in communications and information processing, for instance, have lowered the cost of obtaining financial information on prospective customers. These improvements have also allowed many new products to be created and marketed to a much wider audience, thus opening the door for companies to reach customers formerly served by other types of institutions. A number of previous regulatory restrictions, such as deposit interest ceilings in the 1970s, have provided additional incentives for less regulated firms to develop alternative offerings to compete with banking services.

Numerous examples now exist of the new competition in financial services. Many households have increasingly turned away from the traditional savings account instruments offered by banks and thrifts. In the household savings market, money market mutual funds, other types of mutual funds, and cash management accounts have become attractive alternatives to bank deposits. Annuities offered by insurance companies and a variety of new products developed by securities firms are also capturing a significant portion of the savings market.

A new competitive framework has emerged in the credit mar-

kets as well. Issuance of commercial paper has increased substantially over the past few decades, and this market now provides an efficient means for companies with high credit ratings to attract investor funds. The commercial paper market, moreover, has succeeded in taking many prime corporate borrowers away from the banking industry. Another notable lending development is the securitization of financial assets. In particular, securitization has become a major factor in mortgage markets and consumer lending markets, allowing a wide variety of mortgage originators, consumer lenders, and investors to participate in these markets. Credit card competition has also grown substantially, with larger banks marketing cards on a nationwide basis and nonbank firms, such as Sears, General Motors, Ford, and AT&T, capturing a growing portion of the market with their own credit card offerings.

These changes in the competitive environment have created a strong need to reassess the traditional activities of financial institutions and the governmental intervention which contributed to this segmented financial system. Several initial steps in this direction were the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St Germain Depository Institutions Act of 1982. These two acts put depository institutions on a more equal footing with each other in regard to deposit and lending powers, reserve requirements, access to Federal Reserve services, and ability to pay competitive rates on funds. The result of such steps has been more direct price competition between institutions and a substantial increase in the number of institutions that offer transaction services and business and consumer lending.

Subsequent steps toward deregulation have included state and federal efforts to liberalize bank expansion laws and banking powers. Federal court and regulatory agency rulings have also allowed banks and bank holding companies to engage in a broader range of securities activities and a number of other financial services. Problems in the bank and thrift industries during the 1980s and

early 1990s, though, delayed part of this breakdown in regulatory barriers between financial institutions.

Improving conditions in banking throughout much of the 1990s, combined with increasing financial competition and innovation, then set the stage for the most dramatic step in financial deregulation. In 1999, Congress passed the Gramm-Leach-Bliley Act as a means of allowing a greater range of affiliations among banking, the securities industry, insurance, and other financial sectors. This act removes many of the long-standing barriers that have hindered or prevented direct competition among different segments of the financial system. It thus represents a significant departure from the previous approach of segmented financial markets.

Competition among banks, thrifts, and other financial institutions will almost certainly intensify further as organizations take advantage of opportunities created by the 1999 legislation. Moreover, technological innovation will keep on reducing the costs associated with serving customers, help create additional financial products, and allow institutions to continue expanding into new markets. As a result, significant numbers of institutions will be able to venture into new areas and compete directly with more traditional institutions. These new entrants, along with the changing structure of financial markets, though, may also raise many questions regarding which institutions should receive “bank-like” regulation, what level of regulatory protection and concern should be extended to different products, and what consumer protection laws should apply.

SUMMARY

Banking regulation can have a profound effect on competition and efficiency within the banking industry and throughout the financial system. Banking laws and regulations, for example, can influence bank entry and expansion, the products offered by banking organizations, the manner and cost of providing these prod-

ucts, and, in turn, the ability of banks to compete with other institutions. As a result, banking regulation must not only strive to protect depositors and maintain monetary stability, but must also foster active competition and innovation in financial markets.

In recent years, a number of pathbreaking steps have been taken to increase competition for financial services, and most notably among these is the Gramm-Leach-Bliley Act of 1999. Further innovation in financial markets is certain to occur, and the manner in which these developments are regulated and supervised will be important in giving the public access to quality services at reasonable prices and in keeping banking a viable industry capable of meeting public needs.

CHAPTER 7

Regulation for Consumer Protection

Consumer protection is a key part of banking regulation, and public interest in consumer protection laws has increased rapidly in response to the dramatic growth over the past few decades in consumer lending and other consumer banking relationships. Federal regulation to provide consumer protection essentially began with the Consumer Credit Protection Act of 1968, which included the Truth in Lending Act. This legislation was soon followed by other consumer laws, which were passed to address some of the problems and complexities associated with the increased use of consumer credit. Other legislation was enacted because technological advances in banking had outgrown the current body of law, and a new legal framework was necessary if orderly development was to continue. The Electronic Fund Transfer Act is an example of this type of legislation. Between 1978 and 1985, no new additions to the body of consumer laws were enacted. A new wave of consumer protection laws began in 1985, with the adoption of the Credit Practices Rule. Since then, more than a dozen new laws have been enacted, most of which were incorporated into existing regulations.

Consumer protection laws may be grouped into three general categories or objectives. Two can be classified broadly as disclosure laws and civil rights laws. The third category consists of laws designed to protect a consumer's privacy and provide safeguards against specific abuses in the extension, collection, and reporting of consumer credit.

The following sections discuss the regulatory considerations in

implementing consumer protection laws and present the major federal laws in the three general consumer protection categories.

REGULATORY CONSIDERATIONS

Since financial transactions by consumers involve many types of credit and a variety of services, no single method has been used to regulate consumer credit practices or to implement and enforce consumer credit laws. In trying to address particular abuses and practices in consumer credit, Congress has taken a combination of approaches. Some laws forbid certain practices. The Fair Debt Collection Practices Act, for example, in most instances prohibits contacts by a third-party debt collector with people other than the debtor. Other laws require appropriate disclosures to the consumer. The prime example is the Truth in Lending Act, which requires uniform disclosure of credit terms. The theory of disclosure laws is that consumers with adequate information make better financial choices, thereby driving out abusive creditors and practices.

Another approach used by Congress is merely to make unlawful all activities that have a particular effect. For example, the Fair Housing Act broadly prohibits any activity, without specifying the activity, that has the effect of unfairly discriminating in the financing, purchasing, and renting of housing. Finally, as another approach, Congress requires the compilation of data. The best example of this approach is the Home Mortgage Disclosure Act. The intent of this law is to provide regulatory agencies and others with data to help analyze whether creditors may be unjustly excluding particular neighborhoods from receiving home loans. Most consumer protection laws do not take any one approach exclusively but use a combination of them.

Consumer protection laws are implemented and enforced in various ways. Many of the acts are implemented through regulations written by the Board of Governors of the Federal Reserve System. In other cases, such as the Community Reinvestment Act,

each federal agency must write its own regulation to be applied to institutions under its direct supervision. The Department of Housing and Urban Development (HUD) is in charge of implementing regulations for the Real Estate Settlement Procedures Act. The Homeowners Protection Act of 1998, on the other hand, has no provision for the promulgation of regulations. In this case, all enforcement practices are based on provisions of the act itself.

Enforcement of the consumer laws for depository institutions is the responsibility of the institution's primary federal supervisory agency. Examinations and, to a lesser extent, investigations of consumer complaints are used by the regulators to check compliance. For nondepository creditors, such as retail stores and finance companies, the Federal Trade Commission has primary responsibility for enforcing consumer laws. Because of the large number and variety of such firms, the Federal Trade Commission relies principally on consumer complaints to ensure compliance.

Violations of consumer laws by depository institutions are generally corrected during the examination process. Examinations normally entail the prospective correction of particular practices, and the correction is made voluntarily. However, remedial action is required for certain violations of the Truth in Lending, Equal Credit Opportunity, and Fair Housing Acts. Violations of some provisions of the Real Estate Settlement Procedures Act and Flood Insurance Protection Act can trigger civil money penalties, assessed either by the Secretary of HUD or the institution's primary supervisory agency. Where voluntary compliance is not achieved, regulatory agencies must use their enforcement powers.

Most of the federal credit laws can also be enforced by individual consumers through civil lawsuits. Successful individuals are entitled to an award of actual damages, court costs, attorney fees, plus punitive damages in some instances.

DISCLOSURE LAWS

Truth in Lending Act— Federal Reserve Regulation Z

The best known of the disclosure laws is the Truth in Lending Act. It was enacted in 1968 as Title I of the Consumer Credit Protection Act and is implemented by Federal Reserve Regulation Z. The act is enforced by a depository institution's primary federal supervisor and by the Federal Trade Commission for most other lenders.

With the rapid growth of consumer credit in the late 1960s, Congress became concerned that consumers might be confused by the many different ways that lenders charged them for credit. Consumers might be quoted an add-on rate, a discount rate, a simple interest rate, or a compounded rate. Rather than legislate the method for imposing credit charges, Congress left the individual states with the authority to set credit terms but required lenders to disclose these terms in a uniform manner. The intent behind uniform disclosures was to provide consumers with the information they would need to compare credit terms and make informed decisions on the use of credit.

To do this, the Truth in Lending Act establishes standard disclosures for consumer creditors nationwide. Important loan terms must be disclosed in uniform terminology, with rules for each type of credit. For example, the cost of credit must be disclosed as a dollar figure, known as the "finance charge," and as a yearly rate, known as the "annual percentage rate."

The Truth in Lending Act is an extremely complex, technical body of law. The act was simplified in 1980, but the evolution of financing alternatives has resulted in numerous amendments to cover such products as variable-rate loans, home equity credit lines, reverse mortgages, and high-cost mortgage loans. Amendments to the Truth in Lending Act are further increasing its use as a vehicle for prohibiting or restricting creditor policies and practices, espe-

cially on loans secured by residences. One example is the lifetime rate cap rule for adjustable-rate mortgage loans, which protects consumers from unlimited rate increases that might cause them to lose their home.¹

General provisions—Regulation Z applies to consumer credit offered primarily for personal, family, or household purposes. Extensions of credit primarily for business, commercial, or agricultural purposes are exempt from all but certain credit card rules. Only creditors that regularly extend consumer credit are subject to Truth in Lending, and Regulation Z provides a numerical test for determining whether a creditor is covered.

The regulation makes a distinction between open-end and closed-end consumer credit. Open-end credit can generally be characterized as revolving lines of credit on which a finance charge may be imposed on the outstanding balance. Typical examples of open-end credit are credit cards, overdraft protection plans, and home equity lines of credit. Closed-end credit is defined by exclusion: it is any consumer credit that does not meet the definition of open-end credit. Home purchase loans, home improvement loans, car loans, and demand loans are examples of closed-end credit.

The keystone to Truth in Lending is disclosure of the basic credit terms in a uniform manner. The most crucial disclosures are the finance charge and the annual percentage rate.

Finance charges—To make sure that credit disclosures are uniform, the regulation sets out strict rules for the items to be included in the finance charge figure. Any charge payable by the consumer and imposed by the creditor as an incident to or a condition of the loan is a finance charge. A finance charge might be directly or indirectly paid or imposed. Examples of finance charges are interest, loan origination fees, premiums for mortgage guaranty insurance, cash advance fees, and credit report fees. If the charge is

¹ The rate cap rule was established under Title XII, section 1204 of the Competitive Equality Banking Act of 1987 (12 U.S.C. §3806).

payable in a comparable cash transaction, it is not a finance charge. Property taxes, for instance, are not finance charges since they are due regardless of whether credit is involved.

There are several exceptions to the general definition of finance charge. The most important pertain to charges often assessed on loans secured by real property, such as title examination fees, credit report fees, and appraisal fees. None of these are included in the finance charge on real property loans, provided they are bona fide and reasonable in amount.

Annual percentage rate—The annual percentage rate (APR) is the cost of credit expressed as a percentage of the unpaid balance. It relates the total finance charge to the net amount of funds used over the life of the loan. This converts add-on, discount, and other types of interest rates and charges into a uniform measurement that consumers may use to compare the prices of different loans. The APR is similar to a lender's internal rate of return on a loan. However, the APR is unique because Regulation Z has its own definitions of the components going into the finance charge. Special rules and equations in the regulation and its appendices explain how to calculate the APR for open-end and closed-end transactions.

Regulation Z allows for errors in disclosing finance charges and APRs. The disclosure tolerance depends on a variety of factors, but it is generally larger for mortgage loans than other types of loans.² The regulatory agencies must order restitution to consumers where a lender is found to have engaged in a pattern or practice of understating the cost of credit.

Open-end credit—Creditors offering open-end credit plans must disclose important terms of the plan before the first transaction occurs. These "initial" disclosures include such information as how the finance charge and account balance will be computed, the

² The larger tolerance for mortgage loans was adopted following passage of the Truth in Lending Class Action Relief Act of 1995. This amendment was a Congressional response to class action lawsuits involving relatively minor disclosure errors.

periodic and annual percentage rates used to compute interest, and other charges that could be imposed.

Consumers with open-end credit accounts must regularly receive a statement that itemizes account activity and discloses the finance charge and APR for the billing cycle. If the consumer believes there is an error on the statement, the provisions of the Fair Credit Billing Act apply. This act, implemented by Regulation Z, establishes the rights and responsibilities of the parties involved in a disputed open-end credit bill. Each party has specific procedures to follow in order to protect their rights and limit liability.

In addition to these general requirements for open-end credit, the act and regulation include a few special rules for credit cards, charge cards, and home equity plans. Among these is the requirement that applications and solicitations for credit or charge cards include full disclosure of the account terms and conditions. This rule was included in the Fair Credit and Charge Card Act of 1988 and is designed to provide consumers with information before they pay a nonrefundable fee or make a deposit to secure a card. The regulation includes other protections that apply only to credit card accounts, such as prohibiting the issuance of unsolicited cards and limiting a cardholder's liability to \$50 for unauthorized transactions.³

The home equity rules contain a number of provisions to help consumers shop for this type of credit. For instance, lenders must disclose extensive information about their plan when they provide an application form.⁴ Other home equity provisions restrict lender actions. To prevent manipulated rate increases, for example, lenders may not increase the APR if they use an internal interest rate index. Lenders must also have legitimate reasons for changing

³ These credit card rules are the only two provisions of the act and regulation that extend to business, agricultural, and other types of credit. A credit card issuer may negotiate higher liability limits when it issues 10 or more credit cards for the use of employees of an organization. 12 CFR 226.12(b)(5).

⁴ The home equity rules were adopted following passage of the Home Equity Loan Consumer Protection Act of 1988. They apply to plans secured by the borrower's dwelling, including second and vacation homes.

the rate index, reducing a borrower's credit limit, or preventing additional advances after the account is opened.

Closed-end credit—There are 18 “material” credit terms that must be disclosed on closed-end loans. Six of these items are critical, as they carry civil liability exposure if omitted or misstated: the amount financed, payment schedule, total of payments, finance charge, APR, and collateral requirements.

For most closed-end loans, creditors can provide the disclosures just before consummation, which is when the borrower becomes legally obligated on the loan. However, for a home purchase or construction loan, disclosures are to be given shortly after an application is received. The intent of these earlier disclosures is to encourage comparison shopping by consumers on the most important credit decision they typically will make.

As adjustable-rate mortgages (ARMs) became prevalent, the act and regulation were amended to require that consumers receive information about a lender's ARM program before they apply. Among the disclosures that must be made are how interest rates will be determined, how often rates and payments will change, and an example of how monthly payments can be affected by a rate increase. These “program” disclosures are given along with a standardized pamphlet designed to help consumers understand ARM features such as negative amortization and rate and payment caps.

The Home Ownership and Equity Protection Act of 1994 was passed in an effort to protect the interest consumers have in their homes and to address two emerging types of home loans: “high-cost” and reverse mortgages.⁵ The high-cost home loan rules include special disclosures and restrictions that seek to prevent abusive practices in lending to persons of modest means and to provide applicants with information for making an informed credit decision. Among the abusive or predatory lending practices these rules

⁵ This act is Subtitle B of Title I of the Riegle Community Development and Regulatory Improvement Act of 1994.

prohibit are the extension of credit without regard to a consumer's repayment ability and the use of such lending provisions as prepayment penalties, rising interest rates after default, balloon payments, or negative amortization. Several special disclosures are also required for reverse mortgages, which have unique characteristics and are most often used by elderly borrowers.

Right to Rescind—When consumers put up their primary dwelling as collateral for a nonpurchase money loan, the lender must provide them with notice of their right to rescind the loan.⁶ This right gives consumers a three-business day “cooling off” period to reconsider their decision and is a leverage against unfair and deceptive practices. Until the rescission period expires, the lender may not advance any money except into escrow, perform any services, or deliver any materials. Consumers may waive their rescission rights only if they have a bona fide personal financial emergency that must be met before the end of the rescission period.

The right to rescind applies to both open- and closed-end credit and probably subjects a creditor to more potential liability than any other provision of the Truth in Lending law. If handled improperly, the right to rescind can continue for up to three years. Even if the creditor initiates foreclosure within that three-year period, the consumer may have the right to rescind on a closed-end loan.⁷

Advertising—The act and regulation set rules for advertising both open-end and closed-end credit terms. These rules cover creditors and anyone else who advertises the availability of credit. Only the credit terms actually available may be advertised, and rates must be stated as annual percentage rates. To promote full

⁶ A “nonpurchase money loan” is a loan in which the proceeds are not used to purchase the dwelling. Loans for the initial purchase or construction of the borrower's primary dwelling are exempt from the rescission rules. Refinancings of a home purchase loan by the same creditor are also exempt to the extent no new money is advanced.

⁷ The consumer's ability to rescind after foreclosure is initiated was part of the Truth in Lending Class Action Relief Act of 1995. See 12 CFR 226.23(h) for the information on when this right applies.

disclosure, Regulation Z requires other terms be included in an advertisement when certain “triggering terms” are used.

Conclusion—The Truth in Lending Act remains a difficult, complex law despite its simplification in 1980. There are tools, however, that can aid in preparing the various disclosures. The appendices to Regulation Z contain model disclosures and forms that, when properly used, will protect a creditor from liability. Some private vendors have also developed automated disclosure platform systems to assist creditors in complying with Regulation Z.

Consumer Leasing Act of 1976— Federal Reserve Regulation M

The Consumer Leasing Act of 1976 requires meaningful, accurate, and uniform disclosures of consumer lease terms. Like the Truth in Lending Act, the Consumer Leasing Act is intended to facilitate shopping for financial services. It also addresses consumer (lessee) liability at the end of a lease, establishes procedures for resolving disputes over the consumer’s final liability, and standardizes lease advertisement disclosures.

The act was an amendment to the Truth in Lending Act, and it was first implemented through Regulation Z.⁸ However, when Regulation Z was revised in 1981, the consumer leasing provisions were extracted and compiled into Federal Reserve Regulation M. Most recently, the Economic Growth and Regulatory Paperwork Reduction Act of 1996 revised the act by streamlining its advertising disclosure provisions.

The act generally applies to any lessor that regularly extends, offers or arranges consumer leases of personal property if the contractual obligation does not exceed \$25,000 and has a term of more than four months. Real property, as defined by state law, is

⁸ The Consumer Leasing Act is contained in 15 U.S.C. §§1667-1667e.

not covered by the act. Automobile leases are the most common type of consumer lease subject to the act.

Lessors must provide extensive disclosures before consummation of the lease agreement, which include, in part, the amount of initial payments, end-of-lease charges, and other charges to be paid by the consumer (such as security deposits, insurance premiums, disposition fees, and taxes); an identification of the leased property; a payment schedule; the responsibilities for maintaining the leased property; and the liability for terminating a lease early. Some of the other disclosures include a statement of whether the lessee has the option to buy the leased property, a description of any security interest that the lessor will obtain in connection with the lease, information on the leased property's fair market value, and a statement regarding lessee liability at the end of the lease if the realized value of the leased property is less than the residual value (i.e., remaining lease payments).

All of the required disclosures must be made together on a dated, written statement signed by the lessor and lessee, such as in the lease contract. In 1998, the Federal Reserve Board amended Regulation M to require the segregation of some key disclosures and recommended a disclosure format that resembles the initial disclosure requirements of Regulation Z for closed-end transactions. The Appendix to Regulation M contains model lease disclosure statements.

Special disclosure provisions apply to open-end leases, which represent only a small portion of the consumer leasing market but can result in greater consumer liability. In open-end leases the consumer must pay the difference between the residual value of the leased property and its realized value at the end of the lease term and assumes the risk that the realized value may be substantially less than was initially estimated. Closed-end leases are sometimes called "walk-away" leases because the consumer has no liability for the difference between the residual and the realized value at the end of the lease term.

New lease disclosures are usually required when a lease is renegotiated or extended, but there are exceptions. New disclosures are not necessary even for renegotiated or extended leases, provided the lease is being extended for no more than six months or is extended on a month-to-month basis for up to a six-month period. In addition, new disclosures are not required when there is a reduction in the rent charge, payments are deferred, or, in certain circumstances, when leased property will be added, deleted or substituted for other property of equal or greater value. New disclosures are also not required for lease assumptions.

Not only are radio, television and magazine advertisements subject to the act, but other medium, such as merchandise tags, are as well. Lessors that advertise a lease rate or the amount due at lease signing must disclose these terms in a "clear and conspicuous" manner, and the lease rate may not be stated in terms of an annual lease rate or annual percentage rate. A lessor advertising any payment amount or the amount of any capitalized cost reduction or other payment triggers the requirement to make additional disclosures. Liability for inaccurate or false advertisements always rests with lessors instead of with the owners or employees of the advertising medium used.

The Consumer Leasing Act and Regulation M are enforced by the same agencies that enforce Regulation Z. Civil suits for noncompliance may be brought within one year of the violation, and an aggrieved party may be awarded a civil penalty equal to 25 percent of the total lease payments, not to exceed \$1,000 or less than \$100, plus actual damages, court costs, and reasonable attorney fees. Class action suits might result in an award of the lesser of \$500,000 or one percent of a lessor's net worth.

Real Estate Settlement Procedures Act of 1974— Regulation X of the Department of Housing and Urban Development

Passed by Congress in 1974, the Real Estate Settlement Procedures Act (RESPA) requires lenders to inform borrowers of mortgage loan settlement charges. RESPA also seeks to ensure that home loan costs are bona fide by prohibiting kickbacks for settlement services. More recent amendments cover the administration of escrow accounts and other aspects of servicing mortgage loans. The act is implemented by Regulation X of the Department of Housing and Urban Development and is enforced by the lender's primary federal regulator.⁹

RESPA applies to federally related mortgage loans. This generally includes any consumer purpose loan secured by a lien on a one- to four-family residence, mobile or manufactured home, or condominium unit. Business and agricultural loans that are exempt from Truth in Lending are also exempt from RESPA, even if they are secured by a one- to four-family residence.

Applicants for loans subject to RESPA receive three documents designed to help them plan for loan closing. These include information on whether the loan servicing rights might be sold or transferred, a HUD booklet describing the settlement process, and an estimate of their closing costs.¹⁰ At closing, they receive a final statement of settlement charges, as well as an initial escrow account statement.

Loan servicers who escrow for taxes, insurance, or other charges provide borrowers with annual escrow account statements. To pro-

⁹ HUD prescribes the forms to be used in making the various disclosures. Sample forms are in appendices to the regulation or are available on HUD's RESPA website at http://www.hud.gov:80/fhalsfb/res/RESPA_bm.html. This site also includes answers to commonly asked questions about RESPA.

¹⁰ Only the notice of servicing rights is required if the lender denies the loan within three business days of application.

protect borrowers against excessive escrow balances, RESPA limits the amount of escrow that can be collected and requires that excess balances be refunded. Borrowers may not be required to maintain more in escrow than is necessary to pay the aggregate amount of escrow expenses projected for the next 12 months. As a safeguard against shortages caused by interim increases in taxes, insurance, or other escrow expenses, servicers may also collect a two-month cushion.

RESPA was amended in 1992 to address problems consumers were experiencing when their loan servicer changed. They were not being notified of a change in time to direct their next payment to the new servicer, resulting in a late payment charge. Others had difficulty contacting the proper party in the event of a question or dispute. Borrowers now have a 60-day grace period to begin sending payments to the new servicer without penalty. Any payment disputes that arise during the life of the loan must be promptly resolved and, until then, servicers may not report these payments as late to credit bureaus.

Lenders, mortgage brokers, real estate agents, and others competing for mortgage business may form tie-in arrangements or refer customers. This can sometimes lead to questionable fees and costs being passed along to the consumer. RESPA addresses this by prohibiting kickbacks and unearned fees in connection with settlement services. No one may give or accept a fee or anything of value for merely referring settlement business. This restriction against kickbacks and unearned fees does not prohibit the payment of reasonable fees for settlement services actually performed.

Penalties for certain violations can be severe. The Secretary of HUD may assess penalties for the failure to send annual escrow account statements. The Secretary and any state attorney general or insurance commissioner can order all persons involved with kickbacks and unearned fees to pay affected consumers three times the amount charged, or consumers may bring private cause of action to recover such amounts. In addition, borrowers may sue

for actual damages and for punitive damages up to \$1,000 if a loan servicer fails to promptly investigate payment disputes.

Electronic Fund Transfer Act— Federal Reserve Regulation E

The Electronic Fund Transfer Act was enacted in 1978, but compliance with the Federal Reserve's Regulation E, which implements the act, did not become mandatory until 1980.

The act resulted from the rapid development of electronic banking and the regulatory dilemmas it raised. In considering electronic fund transfer (EFT) legislation, Congress recognized that electronic banking had simply outgrown existing law:

As with many new developments in data communications, however, the substantial benefits which EFT promises are accompanied by a broad range of new policy questions. Chief among these issues are the rights and liabilities of the consumer who uses an EFT service.

These questions are particularly acute because existing state laws covering checks and Federal consumer protection laws governing credit cards were not drafted with EFT in mind, leaving the rights of consumers, as well as financial institutions and retailers, undefined in the law.¹¹

Opponents felt that legislation was premature and that EFTs should be left to develop without regulation. However, Congress believed legislation was needed not only to protect consumers but also to promote public confidence in and use of EFT systems.

Recent technological advances affecting electronic banking such as the Internet and "smart cards" are requiring Congress and the Federal Reserve to continually review the adequacy of the consumer protections afforded by Regulation E. Federal Reserve staff has addressed several EFT issues through Regulation E Staff Commentary and, to ensure uniformity of interpretation by the regula-

¹¹ Senate Report No. 95-915, 95th Congress, 2nd session, 1978.

tory agencies, joint policy statements issued through the Federal Financial Institutions Examination Council.

The act applies to all financial institutions or others holding consumer asset accounts, such as checking or savings accounts. Accounts covered by this legislation must be established primarily for personal, family, or household purposes. The act defines an EFT as a funds transfer initiated through an electronic terminal, telephone, computer, or magnetic tape for the purpose of ordering, instructing, or authorizing a financial institution to debit or credit an account. Examples of EFTs covered by the act include transactions at point-of-sale terminals, at automated teller machines (ATMs), through pay-by-phone systems, and by means of deposits or withdrawals initiated through the automated clearinghouse system.

In 1984, the definition of an EFT was expanded to cover all transactions resulting from the use of a debit card, even though some transactions may not involve an electronic terminal. Thus, the provisions of the act also apply to paper-based, point-of-sale transactions made with a debit card.

Otherwise, transactions originated by check, draft, or similar paper instruments are not EFTs. This is the case even if the check is a composite check, such as an institution might receive from the federal government, with a computer listing of deposits and the amounts due each. Cash advances directly from a credit card account via an ATM are not considered EFTs since a consumer asset account is not involved. The act also does not cover check guarantee or authorization services, wire transfers, transfers for the purchase or sale of securities or commodities, and telephone-initiated transfers between a consumer and financial institution that are not pursuant to a telephone bill-payment or other prearranged plan. Other laws and regulations already protected most of these transfers and services when EFT legislation was being considered.

In 1996, Congress also exempted from the act need-based electronic benefit transfer (EBT) programs administered by state and

local governments in an attempt to decrease the act's compliance burden on governments.¹² Need-based benefit programs take a recipient's income or other resources into account to determine the level of benefits that individual will receive. EBT programs allow recipients of need-based benefits to obtain their benefits through electronic terminals such as automated teller machines and point-of-sale terminals. State-administered pension, food stamp and supplemental security income (SSI) programs are examples of need-based programs subject to the 1996 exemptions. However, the EBT exemption does not apply to Federally-administered programs or state employment-related benefits.

The nation's smallest account-holding institutions, with under \$100 million in assets, are excluded from the preauthorized transfer provisions of the act. Small institutions must still comply with the act's rules for other types of EFT services, such as ATM cards, and all financial institutions are subject to the act's prohibition against compulsory use of EFTs and its civil and criminal liability provisions.

Congress focused on five major concerns in developing the Electronic Fund Transfer Act: (1) unsolicited issuance of access devices, (2) liability of parties for unauthorized EFTs, (3) resolution of errors, (4) disclosure of terms and conditions and the documentation of transfers, and (5) freedom of consumer choice in selecting a financial institution.

To prevent the unauthorized use of access devices, a financial institution may not issue unsolicited devices without providing some safeguards. This prohibition was based on a history of losses suffered by consumers and credit card issuers when unsolicited credit cards were sent to consumers.

The act imposes responsibility on both the consumer and the depository institution for unauthorized transfers, thus establishing a sharing of risk. It also emphasizes the quick resolution of problems by providing reduced liability for consumers that promptly

¹² Personal Responsibility and Work Opportunity Reconciliation Act of 1996.

inform institutions of the loss or theft of an access device or of any unauthorized EFTs appearing on monthly account statements. Consumers that promptly notify financial institutions of an unauthorized EFT are only liable for the first \$50 of that EFT. Congress rejected the idea of imposing liability based on a consumer's or institution's negligence because of the constant lawsuits that might be required to define and determine negligence. Consumer liability for unauthorized EFTs cannot be increased because of an argument of negligence.

An institution must try to complete its investigation of any EFT error alleged by a consumer within ten business days. If the institution is unable to complete its investigation within ten business days, it may take 45 calendar days to investigate the alleged error if it recredits the consumer's account for the amount in question until the investigation is concluded.¹³ In this way, a consumer is not deprived of the funds for an extended period of time while the dispute is being resolved.

The act and regulation contain several disclosure requirements that are intended to provide not only proof of payment but also a means of confirming EFTs and aiding in the investigation of errors. To provide consumers with information about EFT transactions before the first EFT occurs, financial institutions must disclose EFT terms and conditions to consumers when they open asset accounts that may be subject to the act. Institutions must also provide consumers with a written receipt when an EFT is initiated at an electronic terminal and a monthly statement showing all EFTs occurring against the asset account. Government EBT programs are subject to more abbreviated disclosure requirements.

The act's disclosure requirements also apply to ATM surcharge fees. These fee disclosures, which are contained in Title VII of the

¹³ For point-of-sale transactions, new deposit accounts, and transactions occurring outside of the United States, the financial institution has 20 business days to resolve the error but may take up to 90 calendar days, provided it recredits the customer's account for the amount in question.

Gramm-Leach-Bliley Act of 1999, resulted from public concerns about the widespread assessment of ATM surcharges and their increasing costs. When consumers contract for ATM cards, financial institutions must disclose that the consumer may incur a surcharge fee when the card is used at ATMs not owned or operated by the card issuer. Also, before operators impose a surcharge at an ATM, they must notify the customer of the surcharge and the amount it will be. This notification must take place before the fee is imposed and must be through a posted message on or near the ATM or on the ATM screen. Furthermore, the ATM operator must give the consumer an opportunity to stop a transaction after the surcharge notice is given and thus avoid being assessed the fee.

The act contains several provisions that protect consumers against compulsory use of EFTs. An individual, for instance, cannot be required to make loan payments through preauthorized EFTs as a condition of gaining credit. Consumers also cannot be required, as a condition of employment or receiving government benefits, to establish an account with a particular financial institution for receipt of EFTs.

Expedited Funds Availability Act of 1987— Federal Reserve Regulation CC

This act and regulation, which became effective on September 1, 1988, are intended to assure that customers have timely access to their deposits. Before the act was passed, some institutions placed holds on accounts in the event deposited checks were returned unpaid. Until this hold period expired, customers were unable to write checks or make withdrawals against these deposits and might not earn interest on the funds. Those who were not advised that a hold had been placed were in danger of unknowingly overdrawing their accounts.

Yet several studies indicated that lengthy deposit hold periods were seldom appropriate, since very few checks were actually

returned unpaid.¹⁴ Given the potential consequences to consumers resulting from frozen funds, Congress placed limits on check holds and delayed interest accruals. It further required that customers be made aware of their institution's check hold policies and notified when a hold is placed on a deposit.

Unlike many other consumer laws, the act's protections extend to deposit accounts used for either consumer or business purposes. Not all classes of deposit accounts are covered, however. The regulation applies only to transaction accounts, as defined in Federal Reserve Regulation D. Examples of transaction accounts include demand deposit and negotiable order of withdrawal (NOW) accounts.

The act does not prohibit most check holds but instead sets maximum time frames that an institution can withhold funds. On certain types of checks, such as U.S. Treasury checks or certified checks, institutions generally cannot place holds because the risk of the check being returned unpaid is extremely low. Other types of checks can be held from two to four business days, based on the proximity of the account-holding institution and institution upon which the check is drawn. To protect institutions from losses on higher risk checks and depositors, the regulation sets out specific circumstances under which even longer holds may be placed. These "exception" holds cover situations such as redeposited checks and checks believed to be uncollectible, large deposits, accounts with repeated overdrafts, and new accounts.

Since check hold policies vary, institutions must provide consumers with a written disclosure of their policy when a transaction account is opened. Institutions that do not place holds on all deposits must give the consumer a written notice when a hold is placed. The notice advises the depositor of the amount being held and when the funds will be available for withdrawal or payment of checks written on the account, thereby avoiding an unintentional overdraft.

¹⁴ Studies found that less than one percent of all checks are never paid, and many of those are in amounts of less than \$100.

In computing interest on accounts, the act and regulation require that consumers earn interest on their funds from the date the institution receives provisional credit for the deposit from its check clearing agent. If a check is later returned unpaid, the institution may reverse any interest accrual on that amount.

Prior to passage of the act and regulation, the system for advising the account-holding institution that a check was being returned unpaid was often slow. Checks took an average of seven days to be returned — longer than the maximum hold period now permitted on most checks. Regulation CC contains provisions designed to speed up the check return process. In most cases, institutions will be advised that a check is being returned before the funds have to be made available to the depositor.

Compliance with most of Regulation CC is enforced by the institution's primary federal supervisor.¹⁵ The act and regulation provide for individual and class action lawsuits to be brought. Recovery can include actual damages, attorney's fees, and court costs. Punitive damages for individual actions can range from \$100 to \$1,000, and, for class actions, up to the lesser of \$500,000 or 1 percent of the institution's net worth. The regulatory agencies do not enforce compliance with the check processing rules. Instead, institutions must "police" themselves. The institution liable for losses resulting from violations of these rules is specified in the regulation. The act limits liability to the amount of the check involved in the loss or liability, although higher damages could be awarded where an institution acted in bad faith.

Truth in Savings Act— Federal Reserve Regulation DD

The Truth in Savings Act ensures that consumers receive written

¹⁵ A brochure on Regulation CC compliance is available through the Federal Reserve Board's website at <http://www.federalreserve.gov/pubs/regcc/regcc.htm>.

information about the terms of their deposit accounts. It also governs the advertising of deposits and interest computations. Only deposit accounts opened primarily for personal, family or household purposes are subject to this law. The act is implemented by Federal Reserve Regulation DD, which became effective on June 21, 1993, and is enforced by the institution's primary federal regulator.¹⁶

Different versions of Truth in Savings had been periodically introduced as legislation for more than 20 years. An act was finally passed in response to the growing complexity of deposit products available after interest rate ceilings were deregulated in the 1980s. Institutions began offering consumers a larger choice of accounts, adopting a variety of interest rate structures, minimum balance requirements, and fee schedules. This made it difficult for consumers to determine which accounts best suited their needs or offered the best returns.

Under Truth in Savings, a depository institution must provide a written statement of the terms of a deposit account before a consumer opens the account and also upon request. The most important of these terms is the annual percentage yield (APY), which provides a uniform measurement of the depositor's potential return on a deposit account. Unlike the APR on a loan, which reflects interest and other finance charges, the APY is only a function of the interest accrued. It does not account for any fees or early withdrawals that may reduce the consumer's actual return on funds. Appendices to the regulation set out specific formulas for computing the APY for various types of interest rate structures.

The advertising provisions of the act and regulation apply to both depository institutions and deposit brokers who solicit funds for deposit into an insured institution. The specific rules vary by the form of advertising. For example, printed ads must contain more detailed information than radio ads. In any form of adver-

¹⁶ Credit unions are not governed by Regulation DD but are subject to a similar regulation issued by the National Credit Union Administration.

tisement, the information cannot be misleading or inaccurate, and any rate of return must be stated in terms of the APY.

One of the main benefits to consumers under the act is the requirement that institutions pay interest on the full balance in the customer's account for each day that funds are on deposit.¹⁷ Prior to Truth in Savings, institutions had varying methods for computing the balance on which interest accrued. These included, for example, netting out the reserves institutions must maintain with the Federal Reserve or charging withdrawals against the earliest deposit (also known as "first in, first out"). Although the act places some restrictions on computations, it does not require an institution to pay interest. In fact, institutions may set a minimum balance for earning interest and decide such other key account provisions as what interest rates they will pay and whether they will compound interest.

Other provisions of the regulation apply once an account is opened. If an institution sends regular account statements to consumers, the statements must disclose the time period covered, fees imposed, and the interest and APY earned for the statement cycle. Institutions must also give depositors advance notice of adverse changes in account terms and of maturing time deposits. These advance notice rules ensure that consumers have time to reinvest their funds elsewhere or in another type of account if desired.

Consumers may bring private cause of action for violations by institutions or deposit brokers. Violators can be held liable for actual damages, attorney's fees, and court costs. Punitive damages can also be recovered up to \$1,000 in the case of individual actions or, in class actions, the lesser of \$500,000 or one percent of the institution's or broker's net worth. However, the civil liability provisions of the act are repealed by the Economic Growth and Reg-

¹⁷ Institutions can delay interest accruals on deposited checks until they receive provisional credit for the funds from their check clearing agent.

ulatory Paperwork Reduction Act of 1996, with an expiration date of September 30, 2001.

CIVIL RIGHTS LAWS

Congress has enacted several laws dealing with invidious discrimination, beginning with the Civil Rights Act of 1968. All extensions of credit inherently involve discrimination between those who are judged creditworthy and those who are not. Antidiscrimination laws, however, are aimed at eliminating consideration of any factors that are unrelated to a person's creditworthiness. Illegal discrimination is not only inequitable, but also works to the disadvantage of creditors by cutting off viable customers and lending markets and thus lowering potential returns. Civil rights laws are directed at both intentional acts of discrimination and practices that have the effect of discrimination. The equal credit laws are part of a line of civil rights laws that ensure equal access to housing, employment, education, and public accommodations.

Equal Credit Opportunity Act— Federal Reserve Regulation B

The Equal Credit Opportunity Act, passed in 1974 and implemented by Federal Reserve Regulation B, prohibits certain types of discrimination in personal, commercial, and farm credit transactions. Creditors may not discriminate against an applicant, or discourage a potential applicant, on the basis of race, color, religion, national origin, sex, marital status, age, receipt of income from public assistance programs, or good faith exercise of rights under the Consumer Credit Protection Act.

The regulation applies to anybody who regularly participates in decisions to extend credit. The general rules prohibiting discrimination and discouraging applicants also apply to those who regu-

larly refer potential applicants to creditors or otherwise arrange for credit, such as mortgage brokers. This broad scope ensures that every stage of a credit transaction is covered: marketing, taking applications, making credit decisions, setting or changing loan terms and conditions, reporting loan histories, and collecting on past due loans.

In addition to the general rules, Regulation B has specific prohibitions and requirements. These preclude creditors from making credit decisions or taking actions that might be influenced by discriminatory considerations. One way to do this is by restricting the types of information that creditors can ask of applicants or potential applicants.

The regulation specifies information that either may never be requested (such as birth control practices) or may be asked only in limited circumstances (such as questions about a spouse or ex-spouse). However, it also requires creditors to request certain information on applications for the purchase or refinance of a principal dwelling.¹⁸ This monitoring data enhances the ability of regulators and lenders to identify possible discrimination on home loans.

Even if the information may (or must) be requested, the regulation may prohibit it from being considered. For example, lenders may always ask about an applicant's age, but can only consider it for determining a pertinent element of creditworthiness, to favor elderly applicants, or in a valid credit scoring system. Age (or any other prohibited basis) cannot be used as a reason for imposing a higher rate, terminating a credit card, or pursuing other types of adverse actions.

Discrimination can take many forms, such as using delay tactics to discourage minority applicants from pursuing a loan request. The act therefore requires creditors to promptly process applications and inform the applicant of the credit decision. If a loan

¹⁸ The required monitoring information is race or national origin, sex, age, and marital status. Creditors subject to the Home Mortgage Disclosure Act must also request this information on applications to refinance or improve a dwelling and may do so without violating the Equal Credit Opportunity Act and Regulation B.

request is denied, the creditor must disclose the specific reasons for denial to the applicant.¹⁹ These disclosures ensure that creditors justify their decisions, while helping applicants identify deficiencies they must overcome to ultimately gain access to credit.

Other specific rules address lending practices that historically have discriminated against females. Before the Equal Credit Opportunity Act was enacted, credit histories were often reported only in the husband's name, and married women had difficulty obtaining credit on the basis of their own credit record. Consequently, Regulation B requires lenders to accurately report credit histories and to reflect the participation of both spouses if both were permitted to use the account or were contractually liable.

Another previous practice of some lenders was to approve loans to females only with a male cosigner, typically their husband. This practice kept women from obtaining credit in their own name when they were individually creditworthy. The act therefore forbids lenders from requiring an applicant to have a cosigner or guarantor, if the applicant applies and qualifies for individual credit. This does not prohibit a lender from offering to make the loan with a cosigner or guarantor when the applicant is not qualified. But in doing so, the lender may not require that the applicant's spouse be that party.²⁰

During the early 1990s, fair lending issues again came to the forefront of lender and regulatory concern. Allegations of racial discrimination in particular were the subject of various news articles and studies. One concern was the accuracy and fairness of appraisals of real estate located in racial minority neighborhoods.

¹⁹ There are special denial notice rules for businesses. These are summarized in a brochure available on the Federal Reserve Board's website at <http://www.federalreserve.gov/pubs/buscREDIT/applca3.htm>.

²⁰ State law might require that a spouse or joint owner of property sign certain documents to make the property available to the lender in case of default or death of the applicant. The regulation allows creditors to obtain signatures on these documents if jointly owned property secures the loan or the applicant relies on joint property to qualify. This would normally include the security agreement or mortgage, but not the debt instrument.

Under a 1991 amendment, creditors must inform applicants of their right to receive a copy of the appraisal used in evaluating the loan application. Since applicants now have access to appraisals, creditors and appraisers have more incentive to use only legitimate factors in establishing the value of the property and in deciding creditworthiness.

To provide more fair lending guidance to their institutions, the federal regulatory agencies issued a joint policy statement in 1994 concerning credit discrimination. This statement describes the general principles the agencies will consider in identifying lending discrimination. The statement also encourages creditors to implement programs for self-detecting illegal practices, although there was no initial guaranty that the agencies would not use the information to initiate an examination or conclude a finding of discrimination. A 1996 amendment to the act partially addressed this concern by treating the results of certain self-tests as privileged information.

In the case of depository institutions, the requirements of the Equal Credit Opportunity Act and Regulation B are enforced by the primary federal supervisory agency. For other creditors, enforcement is either through the federal agency or department with regulatory responsibility or the Federal Trade Commission. When possible discrimination is identified, the federal regulatory agencies may refer the matter to the U.S. Department of Justice. Most of the recent referrals have involved higher interest rates and fees charged on loans to racial minorities and elderly borrowers.

Individual and class action lawsuits may be brought under the act. In addition to actual damages, the act provides for punitive damages up to \$10,000 in individual lawsuits and up to the lesser of \$500,000 or 1 percent of the creditor's net worth in class action lawsuits. Successful complainants are also eligible for an award of court costs and attorney's fees.

Fair Housing Act of 1968

The Fair Housing Act, Title VIII of the Civil Rights Act of 1968, prohibits discrimination in the sale or rental of housing and in any part of a credit transaction involving housing. Its credit protections dovetail with many of those in the Equal Credit Opportunity Act, but there are differences in coverage. For example, the prohibited bases of discrimination vary somewhat, and fewer types of loans are covered by the Fair Housing Act.

The prohibited bases of discrimination under the Fair Housing Act are race, color, national origin, religion, sex, handicap, and familial status. As with the Equal Credit Opportunity Act, the lending provisions of the Fair Housing Act do not try to supplant a creditor's judgment of creditworthiness. They seek only to eliminate the use of criteria that have no bearing on individual creditworthiness.

The credit-related provisions of the act cover both secured and unsecured loans to finance the purchase, construction, improvement, repair, or maintenance of a dwelling. They also govern loans secured by residential real estate, regardless of the loan purpose. For instance, a loan to buy business equipment would be covered by the act, if secured wholly or partly by the borrower's residence. The act further prohibits unlawful discrimination in property appraisals and residential loan brokerage services.

There is no regulation implementing the act. Individual complaints may be filed with the Secretary of Housing and Urban Development, and violations of the act can be pursued through individual civil action, as well as by the U.S. attorney general.

Home Mortgage Disclosure Act of 1975— Federal Reserve Regulation C

The Home Mortgage Disclosure Act (HMDA) and the Federal Reserve's implementing Regulation C are part of the civil rights laws, even though they contain only disclosure requirements. The

act was passed to counter any home lending practices that denied or limited the extension of credit based on the racial or ethnic makeup of neighborhoods. Such lending practices, often called “redlining,” have the effect of discriminating against individuals, and the disinvestment can lower the quality of neighborhoods and housing, typically in older, urban areas.

By requiring mortgage lenders to disclose home loan information, the act provides both individuals and public officials with the means of making informed decisions about which lenders are best serving the housing credit needs of their communities and which communities may need additional housing funds. The data can also be used to identify lenders with high loan denial rates, which could indicate discrimination against racial or ethnic minorities and women.

The act and regulation originally applied only to certain depository institutions and their majority-owned subsidiaries, but Congress desired a more comprehensive picture of home lending patterns in urban areas. Thus, the act was amended several times, and virtually all types of mortgage lenders have been covered since 1990. Some lenders are exempt from the regulation because they are small, have limited mortgage lending activity, or receive few loan applications from urban areas.²¹

In addition to expanding the types of lenders subject to HMDA, amendments to the act have substantially expanded the information that these lenders must gather and report. The original act required institutions to report only property locations on loans originated or purchased. Under the revised law, lenders subject to HMDA are required to maintain a quarterly register that records data on each home purchase, refinance, or improvement loan application received. These registers must include, in part, the loan purpose, the loan amount, the property location and the final disposition of each loan requested. Most lenders must also record each applicant’s gender, race, and income level.

²¹ 12 CFR 203.3(a) and (b).

This information is filed annually with the Federal Financial Institutions Examination Council, which merges the HMDA data with census information to produce a series of tables, known as the HMDA disclosure statement, for each lender. Data from the lenders is also aggregated to provide an overall picture of lending patterns within each MSA. Lenders must make both their HMDA disclosure statement and their loan register available to the public.

Since becoming publicly available, the HMDA data have attracted much interest on the part of community groups, researchers, and participants in the mortgage markets. This increased use of HMDA data in analyzing the performance of lenders has pointed out the need for having the data available from a single source. Consequently, through the Federal Reserve Board, interested parties can purchase copies of loan application registers, disclosure statements, and the aggregated MSA data tables. More detailed data analysis tables, which are used by regulators, are also available for purchase.

Community Reinvestment Act of 1977

The Community Reinvestment Act of 1977 (CRA), another of the civil rights laws directed toward the extension of credit, reflects a congressional belief that depository institutions have an obligation to serve their communities. Passage of CRA can be attributed, in fact, to a belief by Congress that some depository institutions were not meeting community credit needs.

CRA is intended to encourage depository institutions to help meet the credit and development needs of their communities, especially the needs of low- and moderate-income neighborhoods or persons, small businesses, and small farms. These needs are to be met in a manner consistent with the safe and sound operation of the institution. The act is not intended to allocate credit. Rather,

it serves as an incentive for depository institutions to take the lead in providing capital for local affordable housing and economic development, reducing reliance on government funding.

The Riegle Community Development and Regulatory Improvement Act of 1994 substantially amended the CRA statute to satisfy critics of the original CRA rating system and to provide some regulatory relief for small institutions. This also presented an opportunity to adapt CRA to reflect the changing face of the industry as banks and thrifts crossed state lines and searched for product niches. Each of the federal bank and thrift regulatory agencies wrote its own regulation for institutions under its supervision. The content of these regulations is virtually identical.²²

CRA performances are evaluated under one of four possible scenarios:

- Streamlined procedures for small institutions²³
- Three-tiered test for large retail institutions
- Limited-scope test for “special-purpose” institutions
- Strategic CRA plans.

Regardless of the evaluation system used, emphasis is placed on the institution’s record of making loans to low- or moderate-income persons, in low- or moderate-income areas, and to small businesses and farms. Institutions also receive CRA credit for “community development” loans, investments, and services.²⁴ After the CRA performance of an institution is evaluated under

²² These CRA regulations are contained in 12 CFR 25 for institutions supervised by the Office of the Comptroller of the Currency, 12 CFR 345 for those supervised by the Federal Deposit Insurance Corporation, and Regulation BB (12 CFR 228) for those under the Federal Reserve’s oversight.

²³ An institution is regarded as “small” if its assets are \$250 million or less and it is not part of a holding company with total banking or thrift assets exceeding \$1 billion.

²⁴ To qualify as “community development,” the loan, investment, or service must involve: 1) providing affordable housing or community services for low- or moderate-income persons; 2) promoting economic development by financing small businesses and small farms; or, 3) revitalizing or stabilizing low- or moderate-income areas.

these procedures, one of four possible CRA ratings is assigned by its primary supervisor. The CRA ratings are descriptive rather than numerical and the terms used are: “outstanding,” “satisfactory,” “needs to improve,” or “substantial noncompliance.”

Small institutions—Small institutions are presumed to have a satisfactory CRA performance if they maintain a reasonable loan-to-deposit ratio; lend throughout their assessment area; have reasonable lending levels to low- and moderate-income borrowers, small businesses, and small farms; and are responsive to written complaints about their community lending performance. Small institutions have the option of being evaluated for a possible outstanding rating using the three-tiered test for large retail institutions.

The Gramm-Leach-Bliley Act of 1999 granted further relief to small institutions by extending their CRA examination frequency. As a rule, small institutions’ CRA performances are evaluated every four years if their current CRA rating is satisfactory and every five years if their current CRA rating is outstanding.²⁵

Large retail institutions—These institutions’ CRA records are evaluated under three broad “tests”: lending, investments, and services. Under the rating system, the lending test is the most heavily weighted, and no institution can receive a satisfactory or better overall CRA rating unless the lending test component is also rated satisfactory or better.

The lending test considers the institution’s record of mortgage loans to low- or moderate-income persons, small business and small farm loans, and community development loans. Lending levels in low- or moderate-income neighborhoods are also considered. Investments and services whose primary purpose is community development qualify for consideration under the other two tests. The service test also evaluates the geographic distribution of

²⁵ The regulatory agencies have the authority to conduct more frequent examinations for reasonable cause or in connection with an application for a deposit facility.

the institution's facilities, ATMs, and other delivery systems, as well as the range of services provided at each facility.

Wholesale and limited-purpose institutions—Depository institutions that operate on a wholesale basis or offer a narrow product line are treated differently than the typical retail institution. These “special-purpose” institutions are rated primarily according to their record of making community development loans and investments and providing community development services. An institution must receive the prior approval of its primary federal regulator to be designated as a wholesale or limited-purpose institution for CRA.

Strategic CRA plans—All institutions have the option to develop and be rated under a strategic CRA plan. The plan must include measurable goals for meeting community credit needs under the lending, investment and service tests, with special emphasis on the needs of low- and moderate-income borrowers and neighborhoods. In developing a strategic plan, an institution is to seek input from members of the public. Strategic plans require prior regulatory approval and the goals set out in the plan must meet the performance standards for either a satisfactory or outstanding rating. These requirements prevent institutions from designing plans that do not meet their CRA obligations.

Data collection—CRA's renewed focus on mortgage, small business, and small farm loans posed a dilemma for the regulatory agencies. In order to fairly evaluate and compare institutions' small business and farm loan records, the agencies needed hard data similar to that available for mortgages under Regulation C. This information deficiency resulted in new reporting requirements for all but small institutions. As a result, institutions must collect and annually report their small business and farm loan activity, as well as their community development loans. As with HMDA data, the regulatory agencies prepare a report of CRA data reported by each institution, known as the CRA disclosure statement. The data is publicly available, both for each reporting institution and, on an aggregated basis, for each MSA and county.

Enforcement—Unlike most banking laws, CRA does not give the regulatory agencies the authority to enforce its purposes and objectives. The act instead attempts to provide institutions with incentives to meet community credit needs. For instance, an institution's written CRA performance evaluation and rating are publicly available. However, the primary incentive is through the process of obtaining regulatory approval to expand activities.

CRA ratings are taken into account when institutions and bank holding companies seek to open a domestic deposit facility, to acquire or merge with another institution, or to form a bank holding company. The regulatory agencies also consider any public comments about the applicant's CRA performance. This process is not new, but the Gramm-Leach-Bliley Act of 1999 made two significant changes. First, for an organization to become a financial holding company, all of the insured depository institutions it controls must have at least satisfactory CRA ratings. Second, CRA is now tied to the nonbanking activities of institutions and holding companies. Institutions and financial holding companies may engage in the new types of financial services authorized by the bill without the prior approval of banking regulators. But a less than satisfactory CRA rating for an insured depository institution or any insured depository institution affiliates will curtail plans to offer or expand such services. Thus, expansion-minded banks and holding companies must ensure that they and all of their insured affiliates or subsidiaries achieve and maintain satisfactory CRA records.

Sunshine provision—Some critics of CRA have alleged that community groups use the application comment process to effectively force institutions into making financial and other commitments to their organizations. The 1999 legislation attempts to prevent abuses by requiring public disclosure of written CRA agreements between an insured depository institution or affiliate

and another party, such as a community group or an individual.²⁶ Each party to the agreement must disclose the full text and all terms of the agreement to the public and to the federal banking agency with supervisory authority over the depository institution. The depository institution or affiliate involved in the agreement must also file an annual report to the appropriate federal banking agency that discloses any payments made under the agreement, the terms and conditions of such payments, and aggregate data on loans, investments, and services provided by each party. In addition, the community group or individuals involved in the agreement must file an annual report with an itemized list detailing how they used their funding. Community groups or individuals may face stiff penalties for willful and material noncompliance or for the diversion of funds or resources for personal gain.

Community Development Financial Institutions

Congress passed the Community Development Banking and Financial Institutions Act of 1994 in an effort to promote economic revitalization and community development in areas underserved by financial institutions.²⁷ While not strictly an equal credit law, the act seeks to help fund community development projects in low- and moderate-income neighborhoods and to assist low- and moderate-income persons. It therefore has many of the same objectives as the Community Reinvestment Act.

Congress appropriates funds annually for the Community Development Financial Institutions Fund, and these funds may be distributed in either the year they are appropriated or over the fol-

²⁶ 12 U.S.C. §1831y. These disclosure requirements apply to written agreements that provide for annual cash payments, grants, or other considerations totaling more than \$10,000, or loans annually aggregating more than \$50,000. Agreements made before November 13, 1999 are exempt, as are individual mortgage loans and contracts or commitments for loans to individuals, farms and businesses at rates that are not substantially below market rates.

²⁷ This act is Title I of the Riegle Community Development and Regulatory Improvement Act of 1994.

lowing year. Two-thirds of this funding is to be directed toward new and existing “community development financial institutions” (CDFIs). The funding level in 2000 was \$95 million.

To qualify as a CDFI under the act, an entity and any affiliates must have a primary mission of community development and must serve a low- or moderate-income population or an area characterized by some form of economic distress. Institutions meeting this definition are eligible to receive funding in the form of equity investments, grants, loans, deposits, or credit union shares. The purposes for which this funding may be used include providing basic financial services and developing or supporting commercial or community facilities, businesses, or housing in targeted areas.

To receive funding, a CDFI must first file an application with the CDFI Fund.²⁸ This application must establish an institution’s qualifications as a CDFI, present a comprehensive plan that analyzes the needs of the area or population and the strategy for meeting those needs, and describe the plans for securing matching funds through other sources. The CDFI Fund has responsibility for selecting institutions with appropriate plans and attributes and for granting assistance to a geographically diverse group of applicants. By 2000, the Fund had certified over 380 organizations as CDFIs.

Although most banks will not meet the qualifications for a CDFI, this legislation provides other opportunities for federally insured banks in community development. A part of the appropriated funding supports the Bank Enterprise Act of 1991, which gives depository institutions insurance assessment credit awards for initiating new community development activities. Qualifying activities include lending in distressed communities, provision of lifeline and other banking services, assistance or equity investment

²⁸ The CDFI Fund, which administers this program, is a government corporation managed by an administrator appointed by the President and confirmed by the Senate. The administrator is advised by a 15-member board, composed of nine private citizens with community development experience; the secretaries of the Departments of Agriculture, Commerce, Housing and Urban Development, Interior, and Treasury; and the administrator of the Small Business Administration.

in CDFIs, and technical assistance regarding personal finances, housing, or new businesses in low- and moderate-income areas. These awards are to be given on a competitive basis by the administrator of the CDFI Fund. Interested parties may wish to visit the CDFI website at <http://www.treas.gov/cdfi>.

OTHER CONSUMER CREDIT LAWS

In addition to disclosure or civil rights considerations, Congress has enacted a number of other consumer credit laws dealing with specific credit practices and the use of customer information. These laws address a variety of different topics, including privacy of consumer financial information, use of flood insurance and private mortgage insurance, and possible abuses in the extension, collection, and reporting of consumer credit.

Fair Credit Reporting Act of 1970

The Fair Credit Reporting Act of 1970 was created in response to the growth of credit bureaus and other consumer reporting agencies. At the time the act was passed, consumer reporting agencies were beginning to assume a vital role in collecting and evaluating information on the creditworthiness of consumers, and this role has become even more prominent in recent years. New technology, including computer systems and electronic transmissions, has increased both the amount of personal information available and the number of people with access to it. As a consequence, the public is becoming more exposed to problems of inaccurate credit and employment information and the inappropriate use of such information.

To address such potential problems, the act sets out requirements that apply to all consumer reporting agencies and users of credit information. A major purpose of the act and its requirements is to extend regulation to the consumer reporting industry,

thereby helping to ensure fair, timely, and accurate reporting of consumer information. The act also places disclosure obligations on banks and other users of consumer reports and requires reporting agencies to provide timely responses to consumer inquiries.

In complying with the act, consumer reporting agencies must ensure that obsolete information is not reported, make a reasonable effort to assure the accuracy of reported information, disclose information to consumers upon request and proper identification, and investigate any disputes over the completeness and accuracy of this information. Also, consumer reporting agencies must provide reports only for legitimate purposes, such as employment or the extension of credit. In its disclosures to a consumer, a credit reporting agency generally must disclose all information in the consumer's file at the time of the request, except for information concerning credit scores or any other risk scores.²⁹

Financial institutions that deny an application for credit on the basis of information obtained from a reporting agency must disclose this to the consumer, along with the name and address of the reporting agency. When the decision to deny a loan is based on information obtained from anyone other than a consumer reporting agency, the creditor must inform the applicant of his or her right to file a written request for the nature of this information. Lenders who request credit bureaus to screen their data files for potential applicants must make a firm offer of credit to all consumers identified as meeting the prescreening criteria.

For depository institutions, enforcement of the act is the responsibility of an institution's primary federal supervisor. Compliance is enforced by the Federal Trade Commission with respect to other entities and reporting agencies subject to the act's provisions.

²⁹ The issue of whether credit scores should have to be disclosed to consumers is a topic that is receiving some legislative attention. In fact, a number of bills have been introduced by state and federal legislators that would require such disclosures.

Fair Debt Collection Practices Act of 1977

The Fair Debt Collection Practices Act is designed to eliminate abusive and deceptive debt collection practices and to ensure that reputable debt collectors are not competitively disadvantaged. The act applies only to a person or institution regularly collecting or trying to collect consumer debts owed to another person or institution.

Under the act, a debt collector may not contact a consumer at an unusual time or place without the consumer's permission; generally may not contact third parties, including employers, other than to obtain information on the consumer's location; and may not threaten violence or otherwise harass any person in collecting a debt. Debt collectors are also prohibited from using false or misleading representations or unfair practices to collect debts.

Financial institutions may be subject to the act if they regularly collect consumer debts for a third party or use a name other than their own in collection efforts. A financial institution is not a debt collector under the act when, in its own name, it collects debts that are owed to it or an affiliate, or in isolated cases collects debts for another party.

Unfair or Deceptive Acts or Practices— Federal Reserve Regulation AA

The Federal Trade Commission Improvement Act, passed in 1975, requires federal bank and thrift supervisory agencies to investigate consumer complaints against the institutions they supervise. Each agency must adopt procedures for providing customers with prompt, responsive action on their complaints. The agencies also use the complaint process to identify acts or practices that might need congressional or regulatory action.

The Federal Trade Commission prescribes the rules for regulating unfair or deceptive practices by creditors that it supervises. Under Regulation AA, the Federal Reserve Board must adopt sim-

ilar rules for commercial banks and their subsidiaries, unless the Board determines that the practices do not exist within the commercial banking industry.

In 1985, the Federal Trade Commission adopted the Credit Practices Rule, which was in turn adopted by the Federal Reserve Board in 1986 as Subpart B of the Board's Regulation AA. The rule applies only to loans for personal, family, or household purposes that do not involve the purchase of real property. Among other things, it prohibits lenders from including clauses in consumer credit obligation contracts whereby borrowers pre-confess judgment or waive their exemption rights for property not securing the debt. These restrictions preserve borrowers' rights to be heard in court before judgment is rendered on a defaulted loan and their property exemption rights under state law.

Banks and their subsidiaries also may not take a security interest in a consumer's household goods unless the loan proceeds are used to purchase the goods or the bank takes a possessory security interest in the goods.³⁰ Prior to passage of the Credit Practices Rule, many lenders routinely took household goods as collateral primarily for the purpose of threatening consumers with repossession if their loan payments were late. However, such household goods seldom had much resale value, and few creditors had any actual intent to repossess the goods.

The Credit Practices Rule also prohibits creditors from misrepresenting the nature or extent of a cosigner's or guarantor's liability should the primary borrower default on the loan. Before cosigners or guarantors become obligated on a debt, they must receive a written notice that describes their liability. Other provisions of the rule address the use of wage assignments and the pyramiding of late payment charges.

³⁰ One example of a "possessory" security interest is a pawn.

National Flood Insurance Act of 1968

The National Flood Insurance Act of 1968 sought to accomplish two objectives: (1) make flood insurance available to residents of flood-prone areas at reasonable rates and (2) encourage local governments to enact land use restrictions that limit future development in flood-prone areas. These objectives reflected a desire on the part of Congress to reduce reliance on costly and often inadequate federal disaster relief measures.

The act created the National Flood Insurance Program (NFIP), which has been a cooperative effort between the federal government and the private insurance industry to make subsidized and unsubsidized flood insurance available in communities that adopt and enforce NFIP floodplain management ordinances. Communities with special flood hazard areas may choose whether to participate in the NFIP, but subsidized insurance is available only in participating communities. Special flood hazard areas are designated by the Federal Emergency Management Agency (FEMA).

Provisions addressing bank and thrift lending in special flood hazard areas are included in the act, as amended. Loans secured by improved real property (or a mobile home on a foundation) that is in a special flood hazard area must be insured against floods if the community participates in the NFIP.

To reinforce the act's insurance purchase requirements for loans in flood-prone areas and improve the financial condition of the NFIP, Congress clarified several provisions of the 1968 law in the National Flood Insurance Reform Act of 1994.³¹ Under the 1994 act, anyone required to obtain flood insurance as a condition of receiving federal disaster assistance must maintain the flood insurance to ensure future access to disaster assistance.

The 1994 act emphasizes lender responsibility for ensuring that flood insurance is purchased when improved real property secur-

³¹ Title V of the Riegle Community Development and Regulatory Improvement Act of 1994.

ing a loan is in a special flood hazard area. Banks and other regulated lenders may not make, increase, extend, or renew any loan on a structure in a special flood hazard area unless flood insurance is purchased in advance and maintained for the life of the loan. If a borrower fails to maintain an adequate amount of flood insurance, the lender must do so on behalf of and at the expense of the borrower. The act also requires lenders to escrow flood insurance premiums if the lender requires the borrower to have an escrow account for other reasons.

If improved real property is in a community that does not participate in the NFIP, lenders generally may make the loan without the property being insured, even when the property is in a special flood hazard area. However, a lender may not originate a federally backed loan in a nonparticipating community if the property is in a special flood hazard area.

Lender liability for noncompliance increased substantially with the 1994 legislation. Lenders may be assessed civil penalties by their regulators up to \$350 per violation, not to exceed \$100,000 per year, if they have a pattern or practice of not properly notifying borrowers that their improved real property is located in a special flood hazard area, not maintaining adequate flood insurance coverage, or not escrowing for flood insurance when required. These penalties do not include other civil and criminal penalties that a lender may face through the court system.

Homeowners Protection Act of 1998

The Homeowners Protection Act is designed to eliminate inequities in the maintenance of private mortgage guaranty insurance (PMI). The statute became effective on July 29, 1999, and its provisions are enforced by the federal banking agencies, without separate rulemaking or interpretive authority.

The primary purpose of the Homeowners Protection Act is to limit the right of lenders to require PMI once a borrower's equity

in his or her home increases to a certain level. In making residential loans, lenders often require PMI when a borrower has less than 20 percent equity in a home. In passing the act, Congress did not take issue with lenders using such insurance as a protection against default and foreclosure on lower equity loans. Congress did object, though, to the widespread practice of requiring PMI for the entire life of the loan, especially once a borrower's equity rises to a level where insurance provides little additional protection to lenders. As a result, the act attempts to put borrowers with low equity at loan closing on par with other borrowers once the default risk to the lender is equalized.

The majority of the act's provisions apply only to new "residential mortgage transactions" with PMI. These are defined as loans for the purchase, construction, or refinancing of a single-family dwelling that is the borrower's primary residence.³² The act requires certain disclosures to borrowers on any loans meeting this definition, and it establishes uniform procedures and standards for canceling or terminating PMI coverage. A borrower's rights, though, are substantially different, depending on whether the borrower or lender pays for the insurance.

For borrowers that pay for PMI, lenders are to provide written disclosures at consummation that generally explain how long the borrower must maintain PMI, as well as an annual notice of a borrower's right to request early cancellation of coverage. Under the act, borrowers that pay for PMI may ask to have this insurance coverage cancelled when their equity reaches 20 percent of the home's original value. To qualify for this early cancellation, the borrower must have a good payment history (as defined in the act), demonstrate that the home's value has not declined, and show that there are no subordinate liens on the property.

³² The act also includes an annual notice requirement for "residential mortgages," which are existing loans secured by a single-family dwelling that is the borrower's primary residence, regardless of the loan's purpose. See 12 USC §4903(b). Mortgage loans insured or guaranteed by the Federal Housing or Veteran's Administrations are exempt from the act.

The act also provides for automatic termination of PMI coverage, generally no later than the originally scheduled midpoint of the loan term and provided the borrower's payments are current.³³ For borrowers who are behind on loan payments, PMI coverage must be cancelled once the loan is brought current. Since the act requires lenders to automatically terminate the insurance regardless of the actual loan-to-value ratio or the borrower's general payment history, lenders have less ability to control their exposure than when a borrower requests early cancellation.

When PMI is cancelled, the borrower must be notified and any excess premiums refunded with 45 days. If PMI is not cancelled because the borrower is ineligible, a notice explaining the reasons must be sent.

Lenders who pay for PMI are not required to automatically terminate that coverage, even if the cost is built into the borrower's interest rate. Borrowers with "lender-paid" PMI loans are also not entitled to request early cancellation of coverage. Lenders must disclose these important differences between lender-paid and borrower-paid PMI on or before the loan commitment date. When a loan reaches the point where it would have been eligible for automatic cancellation as a borrower-paid loan, the borrower must be notified about financing options that may eliminate PMI requirements.

The enforcement agencies must order restitution in the amount of any unearned premiums when PMI is not cancelled by the required date. Borrowers may also bring individual or class action lawsuits for violations. Plaintiffs in individual actions can receive up to \$2,000 in statutory damages. Class actions can involve maximum damages of \$500,000 or 1 percent of the liable party's net worth, whichever is less. These damages are in addition to the recovery of attorney's fees and court costs.

³³ The act sets out certain minimum loan-to-value ratios that can trigger automatic cancellation before the midpoint.

Right to Financial Privacy Act of 1978

The Right to Financial Privacy Act was adopted in response to a 1976 U.S. Supreme Court decision in which customers of financial institutions were ruled to have no right to privacy concerning their financial records at an institution.³⁴ The act creates a legal interest that customers may enforce against federal agencies or employees seeking their financial records.

The act prevents a federal agency from gaining access to the financial records of a customer of a financial institution without the customer's authorization, an administrative subpoena or summons, a judicial subpoena, or a search warrant. Until the agency certifies that it has complied with this requirement, the financial institution must not release the information. A record must be kept of all instances when a customer's information was released under written customer authorization or in connection with an application for a government-insured or guaranteed loan. The record must note the date, name of the federal agency, and information released. Customers are entitled to inspect this record.

Privacy of Consumer Financial Information

In providing services to customers, financial institutions routinely gain access to detailed, confidential information on the financial practices of consumers. For instance, this information might include a person's monetary and credit card transactions, responses provided on loan application forms, loan repayment history, and data from credit reports. Technological advances have further enabled institutions to collect, analyze, and distribute this information in a much more efficient and effective manner than in past years. With this greater availability of information have come increasing concerns over how consumers can protect their

³⁴ *United States v. Miller*, 425 U.S. 435, 96 S.Ct. 1619 (1976).

financial privacy and keep their records from being provided to unauthorized parties.

Before the Gramm-Leach-Bliley Act of 1999, only a limited set of laws addressed a financial institution's use of personal financial information and the right of consumers to be protected against inappropriate or unwanted disclosures. One of these laws, the Fair Credit Reporting Act, has helped to govern the use of information collected by credit bureaus and reporting agencies. Also, the Right to Financial Privacy Act establishes procedures government agencies must follow for access to financial information on individuals. These and other previous legislative acts, though, have not taken a comprehensive approach to addressing consumer privacy concerns.

To address this privacy issue, Title V of the Gramm-Leach-Bliley Act establishes a set of rules to govern the protection and disclosure of consumer financial information by institutions. The act contains three basic requirements:

- A financial institution must provide an initial notice to consumers, which describes the institution's privacy policies and its practices regarding the disclosure of nonpublic personal information to affiliates and nonaffiliated third parties
- A financial institution must also provide an annual notice of its privacy policies to any consumers with whom the institution continues to maintain a customer relationship
- A financial institution must give consumers an opportunity to "opt-out" of having nonpublic personal information about them disclosed to nonaffiliated third parties

These requirements apply to any institutions that are engaged in financial activities as a business, including depository institu-

tions, insurance companies, securities firms, and finance companies. The act and implementing regulations are enforced by an institution's primary federal supervisor or federal functional regulator, the applicable state insurance authority for insurance companies, and the Federal Trade Commission for other financial institutions. Each federal banking agency is responsible for implementing its own regulations and applying them to institutions under its jurisdiction.³⁵ All federal depository institution regulators, though, have worked together to issue regulations that are identical in all major aspects. These privacy regulations became effective November 13, 2000, although compliance is not mandatory until July 1, 2001.

The act and regulations only apply to individuals who acquire financial products or services primarily for personal, family, or household purposes. Companies or individuals who obtain financial products or services for business, commercial, or agricultural purposes are not covered by the regulations. Also, the provisions of the act address the treatment of nonpublic personal information about consumers, which is defined as "personally identifiable financial information" and any list or description derived from personally identifiable financial information not available to the public. Under the act, personally identifiable information refers to any information provided by a consumer to obtain a financial product or service, information about a consumer that results from transactions involving a financial product or service, and any other information a financial institution might obtain about a consumer in connection with providing a financial product or service.

Examples of personally identifiable financial information include information a consumer provides on an application to obtain a loan, credit card, or other financial product or service;

³⁵ These regulations are contained in 12 CFR 40 for institutions supervised by the Office of the Comptroller of the Currency, 12 CFR 332 for those supervised by the Federal Deposit Insurance Corporation, and Regulation P (12 CFR 216) for those under the Federal Reserve's oversight.

account balance information; payment history; overdraft history; and credit or debit card purchase information. In addition, such information could come from consumer reports, Internet “cookies,” or collecting on or servicing a loan. Disclosing the fact that an individual is or has been a customer or has obtained financial services at a particular institution would also be considered personally identifiable information.

Financial institutions generally must provide an initial privacy notice to individuals before or at the time a customer relationship is established on a continuing basis. Thereafter, a privacy notice must be provided to customers on an annual basis as long as the relationship continues. Examples of a continuing relationship with a financial institution would be if the consumer has a deposit or investment account, obtains a loan or has a loan for which the institution has servicing rights, purchases an insurance product, or uses the institution for leasing, advisory, or home mortgage loan brokerage services. Individuals are not considered to have a continuing relationship if they are only involved in isolated transactions with an institution, such as using the institution’s ATM to access an account at another institution or purchasing money orders, cashier’s or traveler’s checks, or airline tickets from the institution.

A financial institution may also need to provide initial privacy notices to consumers with whom it does not have continuing relationships. For instance, a consumer may have applied and been evaluated for a loan by an institution, with this application being denied or withdrawn, or an institution may have sold the consumer’s loan to another party. In such cases, an institution must provide a privacy notice before it can disclose any nonpublic personal information about the consumer to a nonaffiliated third party. This notice, though, is not required if the institution does not disclose such information.

The privacy notices of financial institutions must be clear and conspicuous and must accurately reflect an institution’s policies and practices regarding disclosures of nonpublic personal infor-

mation to affiliates and nonaffiliated third parties. These notices must contain, when applicable, the categories of nonpublic personal information an institution collects, the categories of such information the institution discloses, types of affiliates and nonaffiliated third parties to whom the disclosures are made, categories of nonpublic personal information disclosed on former customers, an explanation of a consumer's right and the procedures to opt out of the disclosures to nonaffiliated third parties, and the institution's policies and practices for protecting the confidentiality and security of information.

A consumer's right to opt out of having nonpublic personal information disclosed to nonaffiliated third parties is a key part of the act and implementing regulations. A financial institution may not make such disclosures unless it has provided a consumer with an initial notice and an opt out notice and has given the consumer a reasonable means and opportunity for opting out. If the consumer chooses to opt out, then the financial institution may not disclose any of the consumer's nonpublic personal information to nonaffiliated third parties except under certain limited circumstances. A consumer's opt-out privileges, for instance, do not apply to information disclosed to a nonaffiliated third party performing services for the institution, provided the third party is contractually obligated not to use the information for other purposes. Other opt-out exceptions include disclosures to law enforcement agencies, consumer reporting agencies in accordance with the Fair Credit Reporting Act, and government agencies as specified under the Right to Financial Privacy Act.

Under the privacy regulations, consumers can thus prevent financial institutions from disclosing nonpublic personal information to most nonaffiliated third parties by opting out of the disclosures. A consumer has the right to opt out at any time and the consumer's opt-out direction is effective until the consumer revokes it in writing or electronically. Even if a consumer ceases the relationship with the financial institution, the consumer's direction

to opt out still applies to any nonpublic personal information the financial institution collected during the relationship.

INTERRELATIONSHIP OF CONSUMER LAWS

Consumer credit regulations come into play in nearly every aspect of banking and, to a great extent, the various laws interact with each other. The interrelationship of these federal laws and regulations can be illustrated by the procedures involved in making a typical home purchase loan.

Advertising—Regulations and laws come into consideration as early as the advertising stage. The Equal Credit Opportunity and Fair Housing Acts prohibit any advertising that would discourage applications on a prohibited basis. The Fair Housing Act also requires that the advertisement contain the equal housing lender logo. Under the Truth in Lending Act, only the terms actually available may be advertised, and rates must be stated as annual percentage rates.

Application process—In taking an application, the creditor must comply with Federal Reserve Regulation B by taking a written application and by requesting certain demographic information about the applicant. The creditor must also be aware of certain types of information that cannot be requested or considered in evaluating the application under the fair lending laws (Regulation B and the Fair Housing Acts). Lenders subject to the Home Mortgage Disclosure Act also record the application on their HMDA register.

At application, the creditor gives the servicing rights transfer notice under the Real Estate Settlement Procedures Act (RESPA) and, if the rate could increase, the ARM program disclosures under Truth in Lending. Within three business days, the RESPA special information booklet, a good faith estimate of closing costs, and the early Truth in Lending disclosures are provided.

Once the application is complete, the creditor notifies the appli-

cant of the credit decision, as well as the right to receive a copy of any property appraisal (Regulation B). If the application is denied, a written adverse action notice must be sent, including any applicable Fair Credit Reporting Act disclosures.

Closing the loan—If the application is approved, the Regulation B rules concerning the signatures of nonapplicants must be followed. Also, the loan terms and conditions cannot be more onerous if that would entail discrimination on a basis prohibited under Regulation B. The Electronic Fund Transfer Act would prohibit the creditor from requiring repayment by electronic means. If the APR could increase, the mortgage contract would need to specify the lifetime rate cap under Truth in Lending.

New Truth in Lending disclosures may be given if the APR at closing differs from that disclosed at application. Lenders must also provide borrowers with an initial escrow account statement and a final statement of the settlement charges (RESPA). Before a new customer signs loan documents, a creditor must disclose the institution's financial privacy policy and information about its procedures for protecting customer records. Borrowers with private mortgage insurance receive information on how long coverage needs to be carried (Homeowners Protection Act).

Servicing the loan—Even after the loan is closed, consumer regulations come into consideration. The lender cannot engage in practices that constitute prohibited discrimination under Regulation B or the Fair Housing Act, including debt collection or foreclosure practices. Lenders are responsible for reporting loan history accurately under the Fair Credit Reporting Act, and this history should reflect the participation of both spouses, if applicable. Nonpersonal financial information about a loan customer cannot be shared with a nonaffiliated third party unless the customer has been given a chance to opt out of such disclosures.

A creditor may also need to put various procedures and controls in place to generate periodic notices to the customer. These include rate and payment change notices under Regulation Z,

annual escrow account statements, annual notice of the right to request early cancellation of private mortgage insurance coverage, and annual notice of the institution's financial privacy policy.

The loan servicer will need to promptly resolve payment disputes and ensure that escrow payments and balances do not exceed RESPA limits. In addition, the servicer must cancel private mortgage insurance coverage when the borrower is eligible and promptly refund any unearned insurance premiums.

SUMMARY

Consumer laws and regulations have increased the responsibilities of banks and added significant cost and administrative burdens. Renewed congressional focus on such consumer concerns as abusive or predatory lending practices, lending discrimination, and customer privacy indicates that these burdens are not likely to decrease substantially. Where possible, the supervisory agencies will continue efforts to minimize the burdens. However, compliance will continue to require careful, day-to-day attention by banks. Managing compliance and its risks are as important as establishing other good banking policies and practices.

CHAPTER 8

Future Trends in Banking Regulation

If past experience is any guide, further changes in the financial industry are certain to occur. While details of these changes cannot be foreseen with certainty, some of the general trends and their regulatory implications are obvious. One example of this is a more competitive banking environment as banks expand geographically into new markets or offer their services through the Internet. At the same time, nonbank firms are offering many of the same financial products as banks, and a significant portion of these firms may now acquire banks under the provisions of the Gramm-Leach-Bliley Act of 1999. Other trends include the development of more complex financial instruments and services, gains in efficiency from technological advances, faster moving and more liquid financial markets, and new tools for better risk management.

In addition to these pathbreaking and evolutionary changes in the financial system is a renewed concern for financial stability. Many countries encountered serious banking problems during the 1980s and 1990s, including the protracted Japanese banking troubles, the U.S. savings and loan collapse, Latin American and Asian currency and banking crises, and real estate and banking problems in Scandinavian countries and other parts of the world. These widespread problems suggest that regulation will have to adjust quickly if it is to keep up with the financial revolution that is now occurring.

Dealing with these trends and problems will be difficult, and any transition will be far from routine. The task of all participants — regulators, bankers, and general public alike — will be to establish a regulatory system that can accommodate financial change,

while continuing to promote the regulatory objectives of depositor and consumer protection, monetary stability, and banking efficiency and competition.

As always, future regulatory changes are likely to be linked to various financial developments or innovations and to unforeseen problems in the banking industry. Several factors that will influence tomorrow's financial system are technological innovation, a changing competitive environment, and current and future banking conditions. Together these factors have the potential for dramatically altering the types of banking services available, the institutions offering such services, and the regulation of these institutions.

FACTORS INFLUENCING FUTURE REGULATION

Technological innovations

A major factor affecting banking and its regulation in the future will be technological change. The continuing development of electronic banking and the growth of new banking products and services are two key examples of how technology is changing the financial system.

Electronic banking, by speeding up transactions, creating new competitors and services, altering banking operations and support functions, and dramatically expanding the reach of financial institutions, is leading to many significant changes in our deposit and payments system. Through internet banking and automated teller machines, banking customers have nearly unlimited access to services beyond a bank's own network of offices. Financial payments and transactions are also following many new forms, such as point-of-sale services, debit cards, automated clearinghouses and similar processing operations, and wire payments. All of these developments are helping to bring banking closer to the customer and are eliminating the need to deal with a physical banking office for many routine transactions.

Electronic banking developments also mean other changes for banks as transactions become faster and funds become more convenient and accessible. Recent developments are enabling customers to shift their funds more readily among various types of bank accounts, financial investments, and other holdings. Consequently, the need for maintaining high, idle transaction balances is diminishing, and banks will have to deal with more rapid movements of funds between bank accounts and other financial instruments.

Another aspect of technology, the development of new financial instruments and tools, is allowing banks to offer a variety of innovative services and better manage their own risk exposures. Banks, for instance, are setting out in new directions in managing interest rate, exchange rate, and other market risks, both for their customers and for themselves. These efforts are an outgrowth of path-breaking developments in finance and economics in such areas as asset and option pricing theories, hedging strategies, and portfolio and market efficiency theories. In addition, vast increases in computing power are opening the door for these theories to be used on a far broader and more intricate scale than before.

Much of this expansion is centering around derivative instruments. Derivatives typically break up and partition the individual risk/return components of more traditional financial instruments, thereby giving individuals, businesses, and financial institutions a better means of managing their own risk exposures. In addition, banks are creating other products and entering a number of new markets, in many cases aided by new technological advances. Some examples are the securitization of loans for sale in the secondary market, an expanding variety of deposit and loan products, and growth in securities and mutual fund activities. In some cases, these activities are introducing more complexity into banking and increasing the need for even closer oversight of bank risk exposure. Many of the activities also will require institutions to make careful assessments of their customers' needs and make a variety of deci-

sions regarding their own balance sheet composition and methods of operation.

Growing competition in providing financial services

A second factor that will influence future regulation is the growing competition among banks and other financial institutions. Banks and a variety of financial firms have developed new services in recent years and have become competitive forces in many different markets. This competition will only increase further with the Gramm-Leach-Bliley Act of 1999 and its provisions for allowing affiliations among banks, securities firms, and insurance companies. These changes in the competitive framework, moreover, have been in response to such factors as financial innovation, unmet needs or profit opportunities, and regulatory incentives and barriers.

The same technological changes that have led to electronic banking and new products are also significantly lowering many of the costs that banks and other institutions face in competing with each other. In past years, the regulatory framework and the extensive office and personnel requirements in banking had discouraged most forms of nonbank entry, as well as bank expansion into new markets. However, an increasing ability to reach new customers and to conduct multi-office operations is giving both banks and nonbank firms the chance to provide new services and enter additional markets.

Within the banking industry itself, competition is increasing as more liberal expansion laws generally give banking organizations the opportunity to enter any market within their own state and any state within this country. In addition, many banking organizations are expanding their customer bases through nationwide marketing, nonbanking activities, and greater use of electronic banking services. Another factor in the changing competitive picture has been the removal of several price and product constraints in banking, thus bringing bankers into more direct competition

with each other. Overall, these trends are substantially increasing the number of potential entrants into individual banking markets and the range of financial services.

Competition from outside the banking industry has taken several different forms. Savings and loan associations and credit unions, for example, have become more direct competitors of banks over the last few decades as a result of obtaining authority to offer transaction accounts and a wider variety of loans. These changes have greatly increased the number of institutions offering checkable deposits, which had previously been available only at commercial banks.

Another source of competition comes from outside depository institutions and includes such entities as securities firms, mutual funds, insurance companies, and finance companies. A number of these organizations have created alternatives to traditional bank transaction accounts, most notably cash management accounts, money market mutual funds with limited check-writing privileges, and various credit card services.

In their lending operations, nonbank firms are also competing more directly with banks. Many of the informational advantages banks once had in making loans are decreasing due to increased financial disclosure, better access to such data by investors, and the growth of credit bureaus and other credit rating services. As a result, other institutions are now able to penetrate bank credit markets, and businesses with good credit ratings are often able to secure competitive financing through nonbank lenders or directly through the capital markets.

In an effort to counter this competition, banks are taking a number of steps themselves. Bankers are making greater use of loan securitization, and they are providing the letters of credit, liquidity backups, and credit enhancements that support various financial market instruments. Other actions include a more active role in securities markets through underwriting, brokerage, and mutual fund activities. These efforts indicate that competition is

likely to continue increasing between banks and other financial institutions, thus creating more pressure for changes in the regulatory system.

Current and future banking conditions

The U.S. banking industry, for the most part, has recovered from the problems of the 1980s and early 1990s when well over 1,000 banks failed and the bank insurance fund was nearly depleted. A vast portion of the banking industry has had earnings well above historical averages throughout much of the 1990s and, in many cases, at or near record levels. Also, during the second half of the 1990s, fewer than ten banks failed in any given year.

In spite of this recent performance, the banking industry is far from being free of significant challenges or potential pitfalls. The competitive environment is putting strong pressure on banks to cut costs and take other steps to preserve profitability. In addition, banks may be entering a period of substantial uncertainty as much of their traditional framework is being changed by internet banking, rapidly moving financial markets, and entry from outside of the banking sector. Also, because of the cyclical nature of banking, a further challenge is to maintain loan quality in the face of rising credit competition and possible changes in the economic environment.

These challenges thus suggest that portions of the banking industry will remain vulnerable to changes in the economic and financial climate and to unforeseen developments. Consequently, the condition of the banking industry will continue to play a key role in the direction of regulatory reform.

IMPLICATIONS FOR REGULATORY CHANGE

Technological change, rising competition in banking, and the future financial and economic environment raise several issues for banking regulation and its objectives of depositor protection, mon-

etary stability, an efficient and competitive banking system, and consumer protection. An additional concern is what regulatory structure will be most appropriate as financial institutions become more uniform in the products and services they offer and as the banking, securities, and insurance industries continue to merge.

Depositor protection and monetary stability

A number of steps were taken in the 1990s to reform the supervisory system and limit deposit insurance fund losses. For instance, legislation passed in 1991 brought in prompt corrective action by supervisors based on a bank's capital level, early and least cost resolution of failing banks, limits on discount window borrowing by undercapitalized institutions, independent audits and accounting reforms, real estate lending guidelines, and annual bank examinations. Other notable supervisory steps during the 1990s included a shift to risk-focused examinations and to functional regulation of financial holding companies with the Federal Reserve serving as an "umbrella" supervisor.

In spite of these significant changes, a number of issues remain to be addressed. One is how these new elements will actually work when they are tested under more severe conditions. Another issue is how to protect depositors and maintain financial stability as banking organizations take on new activities and as other organizations enter banking. Should bank-like regulation be extended to the new activities and new entrants or is another regulatory approach more desirable? Other regulatory concerns include supervising institutions when they can rapidly change their risk profiles or when they engage in complex activities that are difficult to assess. A final group of issues is how to supervise institutions in a manner that is not burdensome, provides appropriate market incentives and discipline, does not put taxpayers at significant risk, and gives institutions the flexibility to adapt to a rapidly evolving financial system.

A variety of suggestions have been made for reforming the supervisory system, and these proposals generally fall within one of three categories: increasing market discipline in banking, reducing the inherent risks in banking, and making supervision more effective. Among the ideas for increasing market discipline are greater financial disclosure, increased use of market value accounting, and periodic issuance of subordinated debt by banks. Other related ideas include deposit insurance reform through lower limits on coverage, co-insurance that exposes large depositors to specified losses, and private deposit insurance. These options thus seek to strengthen market incentives and to use market signals to indicate possible banking problems. Other objectives are to allow regulators to take a less restrictive regulatory approach and give organizations greater flexibility to adapt to a changing marketplace.

Proposals to reduce the inherent risks in banking have generally focused on limiting what activities may be conducted within banks. Some of these proposals would keep banks from moving beyond their traditional deposit and lending activities, while others would impose tighter constraints. As an example, “narrow banking” proposals would require banks to back their deposits entirely with low-risk, readily marketable, financial instruments. Banking organizations would then be allowed to engage in other activities through subsidiaries of the bank or its holding company, provided the banks were insulated from these risk exposures. These proposals would thus serve to protect depositors and the payments system without having to rely on a more extensive supervisory system.

Among the steps that have been proposed to increase supervisory effectiveness are more refined risk-based capital standards, greater supervisory latitude for well-run banks coupled with a more restrictive approach for other institutions, and continued work on risk-focused examinations as a means of identifying and controlling key banking risks. Other suggestions include placing greater reliance on a bank’s internal risk models, credit rating sys-

tems, and risk-management practices in assessing bank risk profiles and capital needs.

Overall, each of these approaches to banking reform and depositor protection offers certain benefits and weaknesses. In some cases, regulatory reform could entail substantial changes to our financial system or reliance on unproven methods. Also, many of the proposals may not be sufficient by themselves to protect depositors and ensure financial stability. However, the present system also has weaknesses, such as its reliance on extensive supervisory oversight and governmental involvement in the business of banking. It also places the federal government and taxpayers at risk in guaranteeing deposits. These shortcomings in banking regulation and reform indicate the difficulty of designing an ideal system for protecting depositors. Such problems also show the need to continue adapting regulation in response to a changing environment.

Efficient and competitive banking system

Financial institutions have been under strong pressure in recent years to become more competitive and more efficient. This pressure is certain to continue as financial institutions compete more directly with one another and as they expand into new activities and markets. Such trends, moreover, are likely to lead to changes in the manner of providing banking services, the types of services provided, the structure of banking, and the regulatory environment.

Interstate banking and changes in banking structure — An important feature in the competitive framework and changing structure of the banking industry is bank consolidation and interstate banking. A notable amount of interstate expansion has already occurred under various state laws and the 1994 interstate banking provisions passed by Congress. As the interstate movement continues, banking regulation will focus on such issues as whether interstate consolidation is leading to better geographic diversification within banking organizations and increased compe-

tition or is concentrating resources and risk within the industry. The current mixture of large organizations with a nationwide focus, regional banks, and small community banks should help to ensure that consolidation carries few adverse competitive effects. In fact, with fewer entry restrictions, a continued growth in nonbank competitors, and increasing use of nationwide ATM networks and internet banking, local banking customers should have even greater access to financial services in the future. These developments thus suggest that the level of competition in banking is not likely to be a strong regulatory concern, although banking risks could become more concentrated as institutions become larger.

Expanded services — A second element in the changing financial structure and competitive environment is the services that financial institutions are allowed to offer. The Gramm-Leach-Bliley Act of 1999 establishes a broader range of services for financial organizations to offer, thereby resolving much of the recent debate over expanded banking services. As financial institutions take advantage of these legislative provisions, a number of regulatory concerns could arise. Among these are the risks inherent in the new activities and the possibility for conflicts of interest. The 1999 legislation contains several provisions to address these issues, but other steps might eventually be needed to deal with any concerns that might arise.

Electronic banking — The ability of individual banking organizations to deliver efficient and competitive services in the future will depend on whether they can take full advantage of electronic banking. Many bank customers now make extensive use of ATMs, ATM networks, debit cards, automated clearinghouse transactions, and other electronic banking services. The most recent development in electronic banking — internet banking — promises to bring even more significant changes into the financial system.

Internet banking, for instance, allows an institution to reach customers no matter where they are located, and customers have an opportunity to deal with any bank offering such services. Addi-

tionally, this and other forms of electronic banking are substantially reducing the cost of many types of financial transactions, as well as the costs that banks incur to attract and reach customers. Consequently, internet banking could radically alter the way banks operate and the manner in which monetary transactions are conducted. It could also affect the current banking structure and competitive framework by enabling banks to reach many new customers beyond their existing office network.

Interstate banking, expanded services, and electronic banking thus appear to be leading to a more competitive and efficient financial system, provided a broad range of institutions can capitalize on these opportunities. While these developments may allow regulators to focus less attention on competitive issues in banking, a variety of other concerns may arise. Regulators will have to watch closely the way these developments play out and the ability of individual banking organizations to maintain their customer base and control the resulting risks.

Consumer protection

Consumer protection laws now cover a wide range of concerns in banking. These concerns include providing meaningful and accurate disclosures to consumers, ensuring fair and equal access to credit on the part of all consumers, protecting customer privacy, and preventing abusive practices in the extension, collection, and reporting of consumer credit. Compliance with consumer protection laws has continued to improve as bankers and consumers gain more experience and familiarity with the laws. However, several aspects of consumer protection are likely to continue receiving close attention.

Fair and equal access to credit remains a very important regulatory and congressional objective. In 1994, the three federal banking agencies, along with seven other federal agencies and departments, issued a policy statement providing guidance to

lenders on preventing discriminatory lending policies. The statement also discussed what constitutes lending discrimination and what the agencies will consider when evaluating an institution's lending policies. Other steps with similar objectives include the 1994 revisions to CRA regulations by the federal banking agencies; the Community Development Banking and Financial Institutions Act of 1994, which funds community development projects in low- and moderate-income neighborhoods; and the actions the Department of Justice has taken against several depository institutions on the grounds of discriminatory lending and avoiding certain neighborhoods in establishing branches. More recently, the Gramm-Leach-Bliley Act of 1999 requires institutions to achieve satisfactory CRA ratings before any affiliated institutions can engage in the expanded financial services specified in this legislation.

Overall, these steps suggest that regulators will continue to place great emphasis on fair lending. For bankers to be successful and achieve regulatory compliance, they will have to put fair lending at the core of their operations and use it as a means of developing the full potential of their communities and their banks.

A related concern is abusive and predatory lending practices. As credit becomes more widely available to all groups, congressional and regulatory attention is shifting to the terms and conditions placed on such credit and whether such terms might indicate abusive lending practices. Abusive lending practices could involve interest rates and fees well beyond the true costs and risk, reliance on collateral with the expectation of borrower default, other fraudulent or deceptive lending practices, and hidden fees or inadequate disclosures of key loan terms. While banks generally avoid such practices in order to protect their reputations, predatory lending is likely to become more of an issue as access to credit continues to expand. Going forward, banking organizations may be under more pressure to justify their credit terms and practices and to defend the lending policies of nonbank affiliates.

Another issue, which received attention in the Gramm-Leach-Bliley Act, is financial privacy. Financial privacy is becoming a greater concern as consumers conduct more and more of their transactions through electronic means and as technological advances enable institutions to collect, analyze, and distribute increasing amounts of information on customers. Protecting financial privacy is still a regulatory issue that is in its infancy. As a result, bankers will have to take a careful approach in balancing the dangers of violating a customer's privacy with the benefits that might accrue to banks and consumers from making more effective use of financial information.

Structure of the regulatory authorities

The U.S. bank regulatory structure consists of three federal banking agencies, plus a banking department in each state. In addition, the Federal Reserve has supervisory authority over bank holding companies. There are also separate federal agencies supervising thrifts, credit unions, and securities firms. State-chartered thrifts face state regulation as well, and for insurance companies, state insurance commissioners have direct regulatory authority. The complexity of this regulatory structure has prompted numerous efforts over the years to reform or consolidate the supervisory agencies, but no significant steps toward regulatory consolidation have occurred. On the other hand, the current system has had some support behind it, because it provides for regulatory diversity and gives depository institutions a choice in how they are supervised.

Reforming the regulatory structure is likely to be a continuing issue as depository institutions become more alike and as they expand on an interstate or international basis and fall under the jurisdiction of additional regulators. Several steps have been taken recently to clarify regulatory responsibilities and address the expansion by financial institutions into new activities and locations. The Gramm-Leach-Bliley Act of 1999 is one such step. This act estab-

lishes a system of functional regulation by allowing each entity in a financial holding company to be regulated by its primary supervisor at the state or federal level. For example, any securities affiliate in a financial holding company is to be regulated by the Securities and Exchange Commission, any insurance affiliate is to be supervised by a state insurance commissioner, and banking affiliates will continue to be supervised by the appropriate banking agencies. As the “umbrella” supervisor, the Federal Reserve has oversight responsibilities for the overall organization, but must rely primarily on the functional regulators to supervise the individual affiliates.

A number of cooperative agreements among regulators have also helped to coordinate supervisory efforts. Interstate banking and branching have led to such agreements among all of the state banking departments, the Federal Reserve, and the FDIC on how to supervise and examine state-chartered banks operating in multiple states. These agreements seek to clarify regulatory responsibilities, foster communication and cooperation among the agencies, and create a “seamless” supervisory system under which a unified approach is taken in supervising individual institutions. Similar agreements have been reached among regulators for supervising other organizations that operate under multiple regulatory jurisdictions, including large complex banking organizations and foreign banking organizations. Other steps toward improving supervisory cooperation include the Federal Financial Institutions Examination Council, which was created in 1978 to create greater uniformity in supervising depository institutions, and a congressional directive to the agencies to develop a system by 1996 for deciding which agency has lead examination responsibilities for a particular banking organization.

Although these steps have helped to address problems associated with organizations having multiple regulators, there is likely to be continued interest in reforming the regulatory structure. Some time will be needed to assess the adequacy and efficiency of the system of functional regulation introduced by the Gramm-Leach-Bliley

Act. Also, many recent efforts at regulatory cooperation have yet to be tested under adverse banking conditions. Another possible factor is what supervisory role will be most appropriate in providing agencies with the insights to carry out their other responsibilities. These include the FDIC's insurance role and the Federal Reserve's monetary, discount window, payments system, and international functions. All of these questions will keep reform of the regulatory structure a topic for continued debate.

SUMMARY

The U.S. regulatory system has undergone many notable changes since banks were first chartered in this country. These changes have been driven by such factors as the banking needs of the public, concerns of bankers, banking problems and crises, political views, and technological advances. Over the past few decades, changes in the financial system seem to be occurring at an accelerated pace. Longstanding geographic restrictions on bank expansion have been removed; banks can now affiliate with securities firms, insurance companies, and other financial institutions; and a vast array of new financial services and instruments are available. In addition, many banking operations are now automated, and a substantial portion of banking business occurs outside of bank offices and other traditional banking channels.

Although the future of the financial system and its regulatory framework cannot be seen with much certainty, further changes are undeniable. Much like the past few decades, revolutionary advances seem almost certain to continue. Many current financial innovations have yet to have their greatest effect, and other significant events and developments will undoubtedly occur. As new ways are found for exchanging goods and services and moving funds between savers, borrowers, and investors, the U.S. regulatory system, once again, will have to adapt to a changing environment. In this process, the public, bankers, and regulators will each have

to examine closely our basic regulatory objectives and determine the best method to meet those objectives.

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